REDUCING RISK IN AN UNPREDICTABLE ECONOMIC CLIMATE

How open data can empower lenders to move confidently through a turbulent economy

experian™

CONTENTS

INTRODUCTION

All industries operate in an environment of constant flux, but the explosion of connected digital technology has caused the pace of change to accelerate significantly. In recent years we have moved swiftly from talking about the potential of big data, to being able to act on insights derived from it.

Today's datasphere is significantly larger thanks to the growth of non-traditional data sources, specifically consumer-contributed data such as bank account transactions. The emergence of these new and valuable data sets, combined with great strides in advanced analytics and technology, now offer us the chance to enhance the entire value chain.

However, while data and analytics provide significant opportunities for growth and improvement, an ongoing climate of financial uncertainty means we also have many challenges to overcome. Every quarter brings new questions for organisations. How will changes in banking laws and regulations affect profitability? Which stress scenarios should be considered? Who are the current 'high-value' customers – and which have the highest opportunity for revenue growth?

In this paper, we will take a considered look at the implications of the current turbulent economic landscape, and explain why a granular, fact-based approach to risk assessment is needed, now more than ever.

We will also offer insights into the different ways data can be used to identify financial stress, while empowering consumers to be more financially responsible. And we will outline a potential new strategy to help you create a revitalised approach to managing risk – one that will help you navigate confidently through these uncertain times.

1.6m
people are in persistent debt

34.8m
active credit cards in the UK

25.6m
people showing 1 or more characteristics of vulnerability

9m
people using credit cards for everyday living

7.7m
have 3+ arrears across more than 3 accounts

55+
Retirement debt is increasing

THE TURBULENT LANDSCAPE

A MACRO-ECONOMIC VIEW

There is no doubt that we are in a turbulent economic time

The UK economy has weakened and is slowing. Typically, the rate of growth has been 2.5% a year, but current rates are less than 1%, (see Fig. 1.0). From Q1 to Q3 2019, the economy contracted by 0.2% (as seen in Fig. 2.0). Sterling is also weaker against the dollar and the euro.

As is perhaps to be expected, UK spending is also slowing. Experian is seeing signs that the rate of spending in 2019 is on average half what it was in 2016, with the decline continuing (see Fig. 3.0).

Fig. 1.0

GDP y-o-y % growth

Spending growth has almost halved

Fig. 2.0

GDP

Growth now below 1%

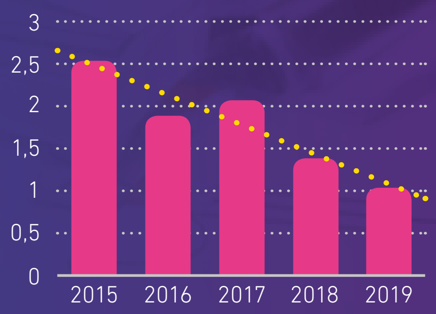
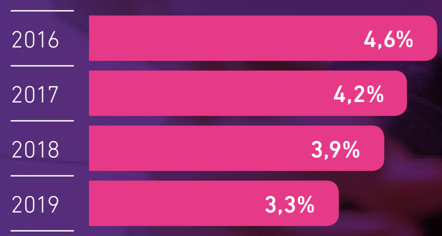


Fig. 3.0

Consumer spending y-o-y% growth

Spending growth has almost halved



Consumers are more stretched

Overall spending may be decreasing, but debt is on the rise, loan defaults are increasing, and renters find themselves unable to get onto the housing ladder. Mortgage loan to value is also going up (see Fig. 4.0).

When asked directly, consumers say they are aware of their financial commitments, but in truth they are not looking far enough ahead. Experian research suggests that with mortgages, car finance and large purchases, consumers view financial commitments on a monthly basis, rather than as an overall total value, with some generational divides.

Salary: painting a different picture

When you break down the trends based on different demographics, you can start to clearly see a pattern emerge that doesn't show such positive accounting. This is especially true for those with earnings of £40-£70k per annum.

Those in the middle salary:

- Use comparison sites the least
- Review their credit file the least
- Check their balances the least

However, the same group also:

- Is most likely to manage their monthly budget using an online tool or an app
- Is the most concerned about their overall debt, with the exception of those who earn £80-95k
- Values trust and reputation; personal recommendation is most important to this group

Many are actively managing their finances

More than 60% of millennials state that they are concerned about their future finances.

Millennials certainly appear to be the most organised about their finances above all other demographics.

30%
check their credit report monthly

1 in 2
millennials check their bank balance weekly

1 in 3
millennials check their bank balance daily

2 in 3
manage their monthly budget though their own spreadsheet, or via a mobile app/site

THE SPECIFICS

Spending and saving

When questioned directly about their spending behaviours, respondents across all age and demographic groups were fairly restrained. Asked how they would pay for a luxury item (in excess of £5,000), 50% of respondents said they would save and wait. 17% said they would use savings, while 10% and 15% said they would use a loan or a credit card respectively.

However, when it comes to more flexible payments such as TV/broadband, food shopping, and eating out/shopping, our research suggests consumers are likely to spend more than they think they do.

50%

spent more, or less, than they thought they did

Spent more than thought	25%
Spent less than thought	25%
Spent same as thought	50%

Breakdown by age	18-21	22-37	38 -53	54 -72	73 -90
Spent more than thought	36%	28%	24%	21%	25%
Spent less than thought	19%	26%	26%	22%	21%
Spent same as thought	45%	46%	50%	57%	54%

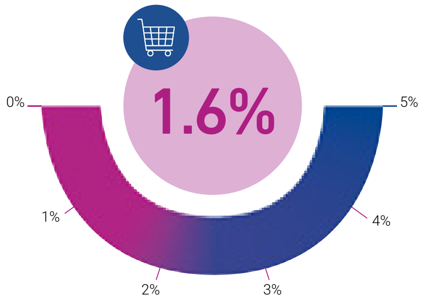
Breakdown by earnings bracket	Less than £20,000	£20,000 - £29,999	£30,000 - £39,999	£40,000 - £49,999	£50,000 - £59,999	£60,000 - £69,999	£70,000 - £79,999	£80,000 - £89,999	£90,000 - £99,999	£100,000 - £149,999	£150,000 - £199,999	£200,000 +
		22%	27%	29%	30%	28%	40%	52%	40%	44%	21%	53%
		26%	24%	27%	27%	33%	29%	20%	35%	34%	50%	26%
		[illegible]%	49%	44%	43%	38%	31%	28%	25%	22%	29%	21%

Living for the moment

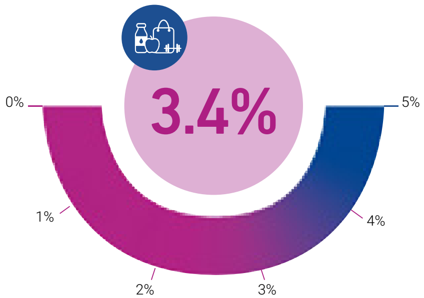
In regard to savings, two out of three millennials say they are saving for the future, while one in two of Generation X says the same. However, one in four of Generation X also say they live for now. One in five people with savings has less than £1000, while 15% of people have no savings at all.

In correlation with this, the average length of time that savings remain untouched has reduced vastly, with a typical regular savings pot lasting just nine months before it is being used. This emulates analysis we have already seen that people's general preference is to spend money on experience-based purchases across the year.

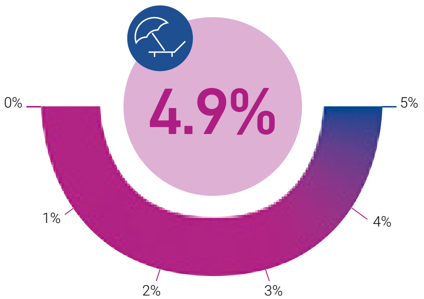
2020 spending forecasts (all households)



Retail



Lifestyle



Holidays

38%

of those aged between 22 and the state pension age are not saving enough for their retirement

Housing

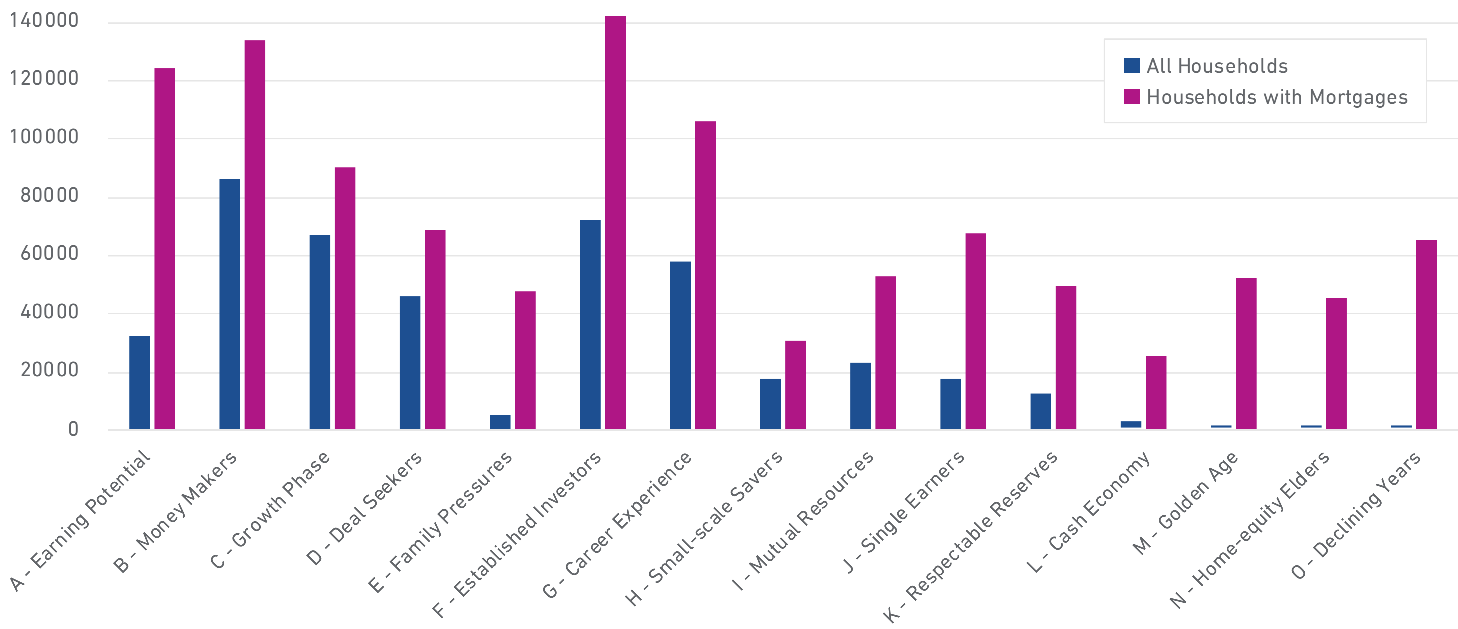
Renters and buyers alike are under financial pressure.

For Generation X, only 25% of those renting are confident that they will buy a property in the future, while 40% say they don't think they will ever be able to buy.

Almost one in two millennial renters, on the other hand, are confident that they will be able to buy in the near future, with 70% of them believing that this will be at some point in the next five years.

Those who are buying a house appear financially stretched. This is evidenced by an increase in mortgages with loan-to-value of 96%+, coupled with an increase in loan terms.

Average Outstanding Mortgage Balances (£)



5 trends in mortgage lending credit demand

01 Mortgage accounts opened with LTV of 96% or higher increased significantly compared to the previous quarter (+10%).

02 Early arrears are emerging earlier, seen across terms of 6,19, and 18 months.

03 The total amount outstanding continued its upward trend observed throughout the past three years into 2018 – rising from £1,309.3bn in 2018 Q4 to £1,316.7bn in 2019 Q1.

04 Default rates (by both volume and value) have risen gradually over the past twelve months, leaving rates at 0.005% on average for the quarter (with absolute volumes still very low).

05 There is a small number of consumers on a relatively high reversion rate who are up to date with their payments, but unable to switch to a cheaper mortgage. These customers are often called "mortgage prisoners".

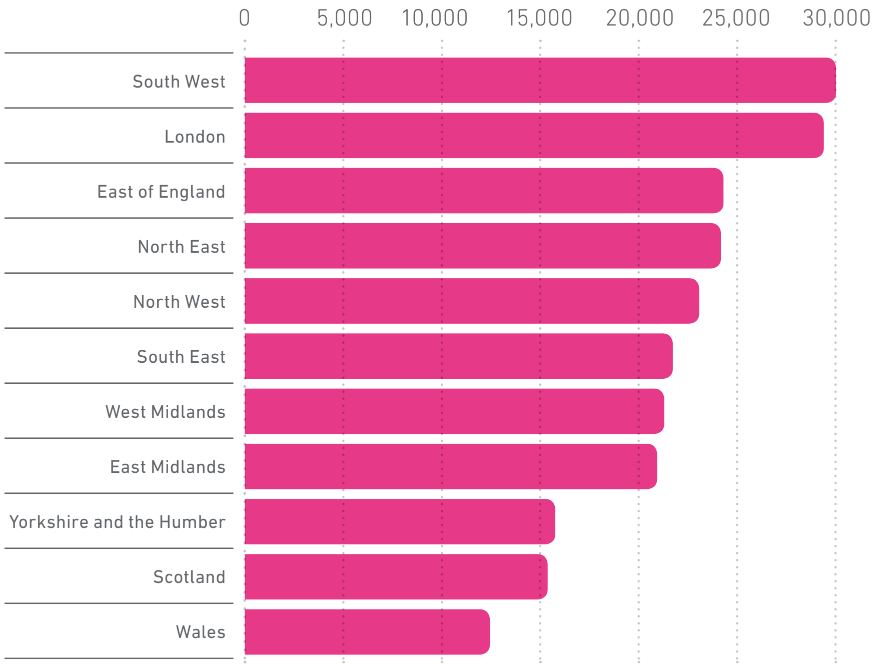
Parental support on the rise

We also see an emerging trend of "The Bank of Mum and Dad". Looking at the additional macro trends, and exploring the rise of lending into retirement, it could well be assumed that retirement equity release is to enable children to buy property. However, as we also clearly see a trend of those nearing retirement spending more on the "now" rather than saving for their future, some of this money will be also be for everyday living.

As a result, there is a significant rise in risk for all parties, as levels of borrowing increase among younger and older generations. With savings also generally reducing by household, it is only a matter of time before this evolves into a greater risk concentration than we currently see when isolating the trends of age groups and demographics.

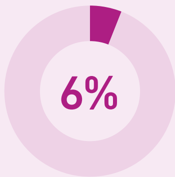
Estimated value of the average "Bank of Mum and Dad" contribution in 2017.

Parents in the South West England are the most generous (£ per transaction)

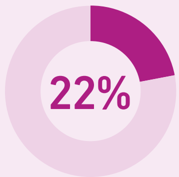


The "Bank of Mum and Dad"

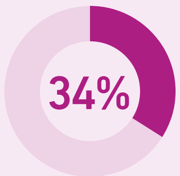
The "Bank of Mum and Dad" is now a top 10 mortgage lender, ranking 6th in the UK.



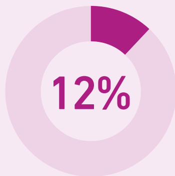
rise in parents offering financial gifts over the last decade



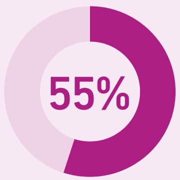
helped with additional fees like stamp duty



of first-time buyers receive help from parents/relatives



are helped to pay the mortgage itself



of children helped with a deposit

The big question: what will happen if there is a shock to the economy?

Experian economic foresight predicts that, in the current climate, a shock to the UK economy as it currently stands should be short and sharp, lasting somewhere between six and nine months. Nonetheless, with debt increasing, defaults already on the rise, and many consumers lacking understanding of their true spending habits, there will almost certainly be concerning consequences.

If, for instance, the Bank of England base rate goes up, and/or the cost of fuel, food, utilities and more increases, many people could find themselves in financial difficulty. What's more, the accompanying increase in the cost of raw materials to businesses would have a knock-on effect, potentially leading to job losses as companies strive to stay competitive and recoup costs. Spending would also decrease, resulting in further contraction of the economy.

As explored earlier, such changes can bring significant impact. From exploring attitudinal behaviours around financial spending, you can see a potential risk emerging beyond disposable income alone. People are living their lives monthly, driven by convenience and ease of access.

Middle-earners most at risk to economic shock

Importantly, this group will be most impacted by an economic downturn, seeing an estimated 15% reduction in available funds due to stagnated wage growth, increasing living costs, and rising energy, food and petrol prices.

This illustrates the increasing importance of considering not just the data points and value sums of financial stability, but individual attitudes. How will this group respond to such an impact to their ability to withstand lifestyle choices? It's critical lenders have the means to test and find out.

In such a volatile climate, there is a serious risk to lenders – both at an operational level, and across the lending industry – in maintaining distance from their customers' true financial status. And that's because even a few small changes to someone's incomings and outgoings could dramatically affect their solvency. If the cost of fuel or food increases, interest rates rise, or jobs become threatened, many people will find themselves in true financial stress. In turn, this will affect the performance of individual lenders and the industry.

Which groups are most at risk of an economic shock?

Overlay Financial Strategy Segments [FSS] onto the economic trends, and you can see some specific risk concentrations emerging. Should the economy contract, the following will feel the most impact on their disposable incomes.

- **E** Family Pressures
- **L** Cash Economy

10% Estimated drop in available funds

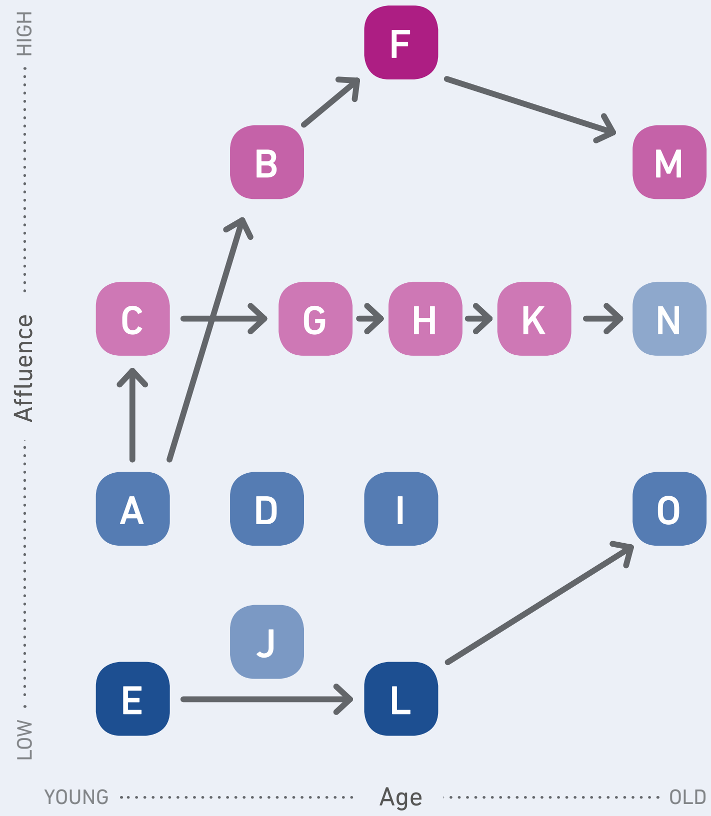
Characteristic of the groups:
Striving to manage their day to day finances on already limited incomes

- **C** Growth Phase
- **D** Deal Seekers
- **G** Career Experience
- **I** Mutual Resources

15% Estimated drop in available funds

Characteristic of the groups:
Growing families with mid-range incomes and high expenses

How demographic groups are likely to change in the next 5 years



HOW TO SURVIVE AN UNPREDICTABLE FUTURE

Today backward-looking and bureau-based risk analysis methods are not enough. Information about a person's financial history, credit score or average industry data only provide insight into past performance or general trends. And as we well know, past performance is not indicative of future results.

The power of certainty

When faced with an uncertain economic future, there are potentially countless scenarios of how events may unfold.

In times of such financial ambiguity, making lending decisions by looking at past behaviours alone – i.e. only using bureau data or market research – is not going to allow you to plan for and mitigate the specific and varied financial risks that may be ahead.

Instead, what's needed is advanced insight into the real, changing financial behaviours and circumstances of applicants, your existing customers, and your whole portfolio, in order to make effective, reliable business decisions in enough time to protect your interests.

The most obvious way to do this is by using the wealth of new data available to you through non-traditional data sources, including that from open banking.

Type of assessment

At the individual level

Open banking brings in bank account data through the PSD2, which offers a more granular view of credit risk. With consent, you can access a person's entire bank account transaction history.

By categorising and analysing this data, you can get insight into an individual's real-time credit risk and affordability and augment existing credit scores.

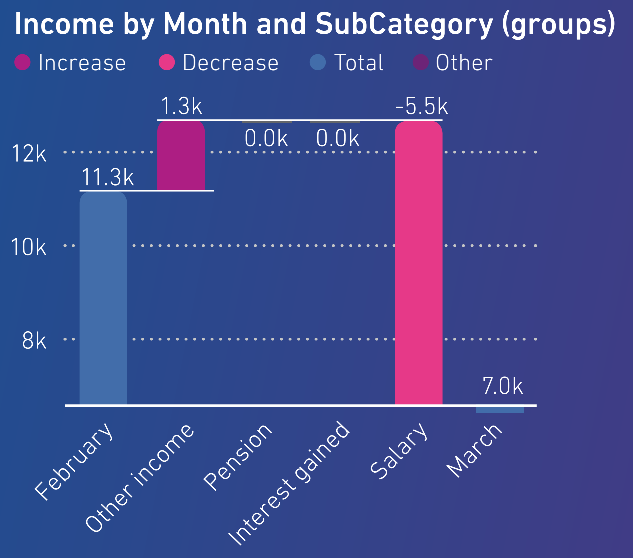
Alongside information about their regular income and loan income, you can start to build a picture of their committed expenditure, discretionary spending, essential expenditure and much more besides.

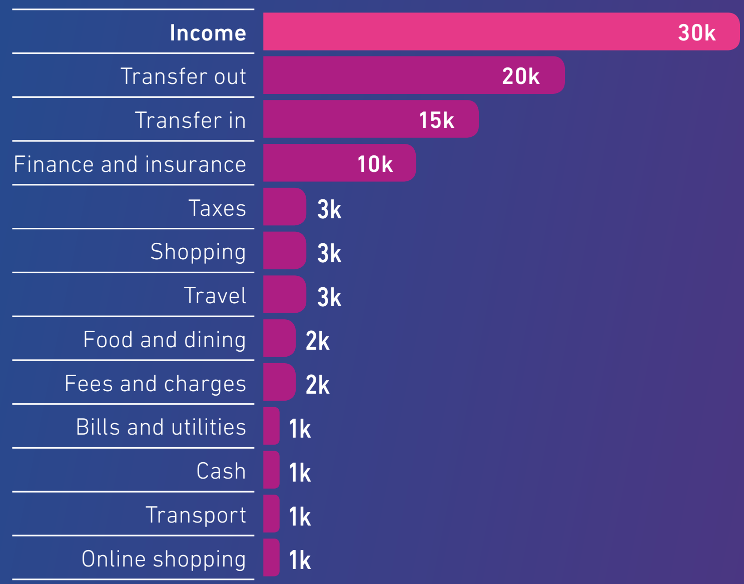
Equipped with this information, you can then 'stress test' it, modelling what happens to each customer in the event of changes to specific personal circumstances, or changes to the financial climate as a whole.

What if?

What if this person loses their job? What if the cost of fuel goes up? What if we enter a recession? What if the interest rate increase? By asking macro- and micro-economic questions of your data, you can discover exactly how a customer's financial situation might shift, giving you an accurate picture of their individual risk.

Going forward, you can then set trigger points, so that you are forewarned of problems in good time and are equipped to take appropriate action.





Identifying triggers through behavioural science

Renters and buyers alike are under financial pressure.

Importantly, you can integrate and automate changes in a customer's behaviour into your modelling. The right decisioning tool will allow you to make decisions in real time, giving you the opportunity to act in, or before, the moment of need.

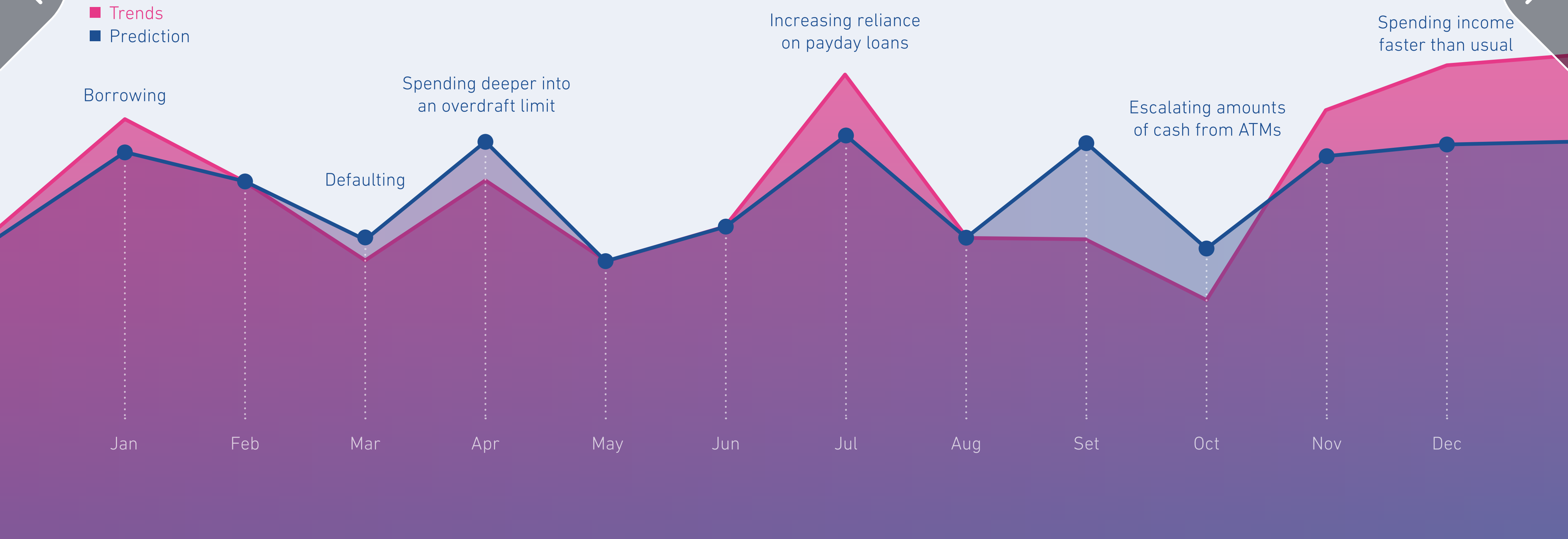
To do this effectively, you must be able to determine patterns of spending over a set period. These can be consistent patterns which repeat themselves, for example:

- Discretionary spending, regardless of funds available
- Regular but small amounts of gambling

Alternatively, the behaviour could be different from usual patterns; for instance, someone might:

- Spend income faster than usual
- Increase their reliance on payday loans
- Spend deeper into an overdraft limit
- Withdraw increasing amounts of cash from the ATM

Moving from trending to predicting



At the portfolio level

Of course, there are far wider business implications. Once you understand behaviours at an individual level, you can start to group these together, for a reliable picture of risk exposure across your whole portfolio.

Having granular customer insight gives you far better insight into your whole business, including more accurate understanding of your concentration risk, loss forecasting, and your capital adequacy requirements.

Essentially, you have the power to create a complete, accurate and dynamic decisioning ecosystem, which has the potential to dramatically reduce your exposure to risk.

Example Brexit overlay on portfolio

Cash Bracket	1. Overcommited	2. Heavy	3. High	4. Low	5. Very Low	TOTAL
1. Secure		9	7	28	1	45
2. Comfortable		10	1	370		381
3. Ticking Over		9		2	2	12
4. Stretched		16	5	54	17	92
5. Distressed	52	42	2	1	3	100
TOTAL	52	86	15	455	23	631

Cash Bracket	1. Overcommited	2. Heavy	3. High	4. Low	5. Very Low	TOTAL
1. Secure			5	3	1	9
2. Comfortable		1	4		2	8
3. Ticking Over				13	1	14
4. Stretched		1	1	351	16	369
5. Distressed	61	80	8	79	3	231
TOTAL	61	82	18	447	23	631

Using real-time trends to make smarter decisions

The advances made in data, coupled with credit scores, have created an opportunity to transform model efficiency and performance. We have moved from:

01 A trend

a customer's willingness to pay, based on insight derived at a point in time

02 Trended

trended data can help you understand patterns across a 12-month period, giving more intricate insight into behavioural spending over the previous twelve months

03 Trending

by integrating additional data sources you can also start to see what is currently trending in a person's behaviour

Overlay this with their capacity to pay, seen through affordability assessments as well as economic forecasts, and you can start to achieve a robust backward and forward view, giving you an ability to model future change.

The benefits of this extend beyond the point at which you first welcome a customer to your organisation. The same data and analysis should be embedded into business processes company-wide.

Equipped with the right insight, everyone across the business can work together to manage risk more effectively, by, for example, tailoring pricing or creating new propositions to suit vulnerable people in a specific climate of risk.

By making better decisions that help to protect your customers, you can lend more responsibly and support the overall economy.

RESPONSIBLE LENDING AND FINANCIAL WELLBEING

Non-traditional data can also support your responsible lending requirements.

The FCA's guidance on responsible lending states a firm must be able to show that the customer's ability to repay was taken into account. In addition, lenders must take account of the customer's actual or reasonably anticipated income in reaching a decision on whether to enter into a mortgage contract.

By testing real customer data, you can carry out thorough checks to ensure affordability at the point of application, sharing this information with your customer so they can be confident your offer is suitable for their circumstances.

Encouraging customer ownership

What's more, through Personal Financial Management (PFM) tools that use open banking data, users can consolidate all their financial information themselves, into a single view that gives them a picture of their financial health. These tools can also make suggestions of how users might change their spending or saving behaviour in order to help them achieve their financial goals.

In this way, you can share the burden of risk, empowering your customers to be responsible for their own financial decisions and overall wellbeing.

HOW TO BUILD A RISK ASSESSMENT STRATEGY FOR AN UNPREDICTABLE CLIMATE

The wealth of financial data available to lenders today has the potential to transform the way customer risk is assessed and managed. But without access to this data, or support from the right technology partner, there is no way to seize the opportunity.

1. Encourage data sharing

The first part of the process is to encourage your customers to share their financial data. This is essential; without this, there is nothing to analyse.

It seems there is still some work to be done to convince customers that data sharing is worthwhile.

The importance of communicating the value exchange

Wider research suggests that some 56% of people within younger generations have already engaged with open banking and shared their data, meaning a data-driven way of banking is very much wanted. However, according to our own research, 50% of people have still not heard of open banking. Of the 50% who do know about it, 60% of respondents had heard about it through the media, and only 34% had heard directly from their bank.

Clearly there is a some work still to be done to clarify, communicate the value exchange, and build trust. The answer is more regular, targeted communications activities, to ensure your customers understand not only what open banking is, but also the wealth of benefits you can offer them if they agree to it.

2. Find the right technology partner

Once consent is achieved, the next step is having the technology to manipulate and analyse your data effectively – and that doesn't just mean open banking data.

Traditional datasets still offer vital value. For a comprehensive picture, you need interconnected platforms that can pull together data from credit bureaux, ONS, research, scorecards, open banking and more. That platform should allow you to drill down into the data as quickly as possible, in order for you to get the detailed insight you need to make both strategic business plans and real-time, spontaneous decisions.

Managing the complexity

The right technology partner should also support you in capturing and storing customer consent, connecting you to each financial institution and consolidating their data into a harmonised view.

Choosing an experienced partner for this work is essential, not least because the volume of data is set to increase. While only nine lenders are currently mandated to provide access to bank transaction data, over time, more will join the initiative. Consequently, it's important to find a technology partner with the systems, processes and support network to handle the volume and complexity of data going forward.

3. Test the art of the possible, and learn from it

In addition to being able to consume and act on new-and-existing data sources, there is an ongoing need to be able to test and learn. By accessing a sandbox environment, you can understand opportunities or risk instantly. You can test a changing scenario, such as interest rate rises, or a reduction in employment – plus much more. It will help you make the most of new data with the latest machine learning techniques in your model analysis and development.

The majority of model development time is taken in creating samples and deploying models in the live environment. With access to new data sources in a test environment, alongside your own, you can gain access to off-book data which will in turn enrich your understanding and knowledge.

Essentially, you will be able to:

- Scale fast, with efficiency
- Accelerate core risk modelling development lead times
- Deploy more frequent model updates to maximise acquisition revenue while managing risk
- Make use of more data, for greater accuracy
- Achieve better outcomes for lower operational costs

> "Credit card transactions are the next phase of opening transactional data and will complete the picture of spending, offering even more insight into behaviours."

CONCLUSION

Turning risks into opportunities: it all starts with the right insight.

The ongoing and unpredictable economic climate presents a serious risk to lenders trying to determine their customers' true financial status.

Even the smallest changes to an individual's income or outgoings could dramatically affect their solvency. An increase in fuel or food prices, a rise in interest rates or even redundancy could place many people in financial difficulty, and in turn affect the performance of individual lenders and the industry.

However, by empowering consumers to share their data, lenders can make faster, more accurate, better-value decisions. To do this you need to be able to take full advantage of the data available from traditional and non-traditional sources – and that is where having the right technology to turn that raw data into clear analysis and insight is vital. Only then can you sensibly influence lending activities at the individual and portfolio level.

ABOUT THE RESEARCH AND INSIGHT CONTAINED WITHIN THIS REPORT

Research insights

Research contained within this paper, unless sourced otherwise, is an extraction from Experian research commissioned through 2018 and 2019. This includes research with third-parties including Forrester Consulting, as well as consumer research conducted on Experian's behalf through C Space. Additional data insights are derived from data sources such as National Hunter.

- Read from our research commission to Forrester Consulting **here**
- To read insight from our Global Data Management trends, **click here**
- For a full view of the UK Fraud trends, please read our **annual fraud report** – also see our Global Fraud and Identity report **here.**

For more information on any specific quotation, **please contact us**.

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.

Our comprehensive data-driven solution for an uncertain economy

Experian offers a range of interconnected data and analytics platforms to help lenders take advantage of real-time modelling in an uncertain economy. Our systems come with the support of our industry-leading team, meaning you can easily tailor them to suit your needs, while quickly adding in new datasets as they become available.

Learn more at **www.experianplc.com**

To find out more about our services, visit our website: **www.experian.co.uk/B2B**