How to effectively manage consumer credit risk in a turbulent economy

April 2020

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Introduction

Before the coronavirus outbreak even began, the UK was seeing a weakening, slowing economy. Then came the virus, and the social distancing measures introduced to slow its spread. Together, they've undoubtedly worsened the economic outlook, significantly disrupting activity and seeing the UK's GDP forecast for 2020 fall.

However, the UK is fighting back, with a raft of unprecedented government measures, not only to bring down infection rates, but also to alleviate the impact of the economic slowdown. As well as promises to protect 80% of many workers' salaries, The Bank of England has made emergency cuts to its base rate and the latest UK budget includes £30 billon of COVID-19 spending.

In this paper, we'll explore some of the key trends emerging from the crisis – including its impact on consumers and credit – and help you navigate what strategies should be prioritized, or amended in order to better protect your business, and consumers.

What does the crisis mean for credit providers' portfolios?

Before COVID-19, overall spending growth was slowing, debt was on the rise and renters were finding themselves unable to get onto the housing ladder. Mortgage loan-to-value levels were at historic highs, with consumers taking on more and more debt to buy their homes, and parents releasing equity from their properties to support their children's deposits.

Further analysis revealed that term extensions have been widely used to make credit affordable. This has gradually consumed spare capacity in the lending market, making the overall market more susceptible to economic shocks. The COVID-19 outbreak has accelerated these trends, creating a difficult economic outlook for the entire UK economy.

As the pandemic progresses, the continuous monitoring of affordability will be critical, not only to help identify stress, and therefore pre-delinquency, but also to protect vulnerable consumers and businesses. Being able to perform affordability checks 'in-life' will bring the value of foresight – something that's needed at speed, and scale.

Greater outstanding debt as consumers feel the strain

As the outbreak unfolds, more consumers will see their incomes fall, and their ability to pay their bills become stretched. As a result, banks are likely to see usually reliable consumers begin to fall behind in their payments, or seek extra borrowing to see them through this difficult time. These new challenges mean it will be more important than ever to monitor what consumers can afford.

Asset quality deterioration as more consumers become at-risk or financially vulnerable

A large number of consumers here in the UK were in debt or financially vulnerable before the pandemic even began. Inevitably, the impact of COVID-19 will see that number rise, triggering a deterioration in lenders' asset quality.

> Large numbers of people are poorly placed to manage that unpredictability - they're not financially resilient. Household saving is at a near-record low, meaning that many people have little or no financial buffer when things go wrong. Family budgets are stretched, with nearly 1 in 10 (9%) of households spending at least 80% of their income on essentials like food, housing and fuel. Finally, household debt is rising and 2.9 million households are struggling to make payments.
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> **Citizens advice bureau: Waling on thin ice report, 2018**[1]

[1] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/debt-and-money-policy-research/walking-on-thin-ice-the-cost-of-financial-insecurity/

Persistent debt will become ever more prevalent

According to the FCA, last year, 3 million adults were in persistent debt and, out of a credit-active population of 35 million people, it's believed 10 million are using credit cards for everyday living, with 3.2 million juggling finance across five or more accounts2. Added to this, 25.6 million consumers have one or more characteristic of being vulnerable, and our own analysis shows 7.7 million are already in arrears on more than three credit accounts – with those rates rising among the over 55s.

> New analysis that maps economically vulnerable groups impacted by the coronavirus pandemic, shows some emerging trends signifying a rise in vulnerability, with a 39% increase in citizens advice around paying or managing bills, and benefit entitlement and access.

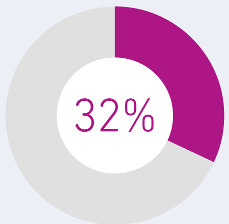
The COVID-19 crisis is likely to exacerbate the problem for an already stressed consumer base.

Fair4all have done some provisional analysis and found:

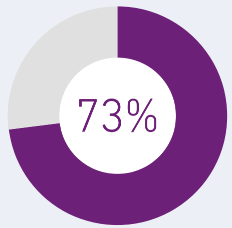
The ONS (2020) finds that approximately

30% of households in the UK report the crisis is affecting their household finances

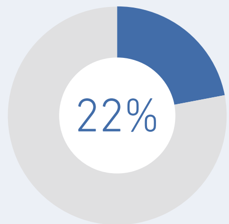
63% report their well-being is affected



report they are using their savings to cover living costs



report a reduction in income



report they are using their savings to cover living costs

Savings gaps inhibit Consumers' ability to weather the storm

UK consumers also exhibit low savings rates, which will affect their ability to weather the COVID-19 crisis and lead to higher borrowing and credit defaults. A recent NMG survey provides proof of this. It asked consumers what their likely response to unemployment would be. The top answer, given by the majority, was to cut back on spending, while the second most common response was to use their savings.

The COVID-19 pandemic will accelerate already-seen signals of distress in the consumer market and the longer and deeper the downturn, the greater the risk that bank earnings and capital will be impacted.

At this stage, certain sectors appear more at risk than others (e.g. aviation, travel, leisure and retail). Furthermore, accounting rules (specifically IFRS 9) have the potential to front load losses (because losses are now calculated as expected rather than incurred).

Fast, immediate intervention and an ability to identify and implement the best next action is critical if credit providers are to safeguard their consumers and their businesses in the short, medium and long-term.

15% of all UK consumers have no savings at all

53% of those aged between 25 an 30 have no savings

1in3 consumers have less than £1500 in savings

According to The Money Charity3, at the end of January 2020, the UK had £1.455 trillion of outstanding mortgage lending and consumers owed a total of £1,680 billion. That equated to an average household debt of £31,845 per adult, of which £4,264 was unsecured.

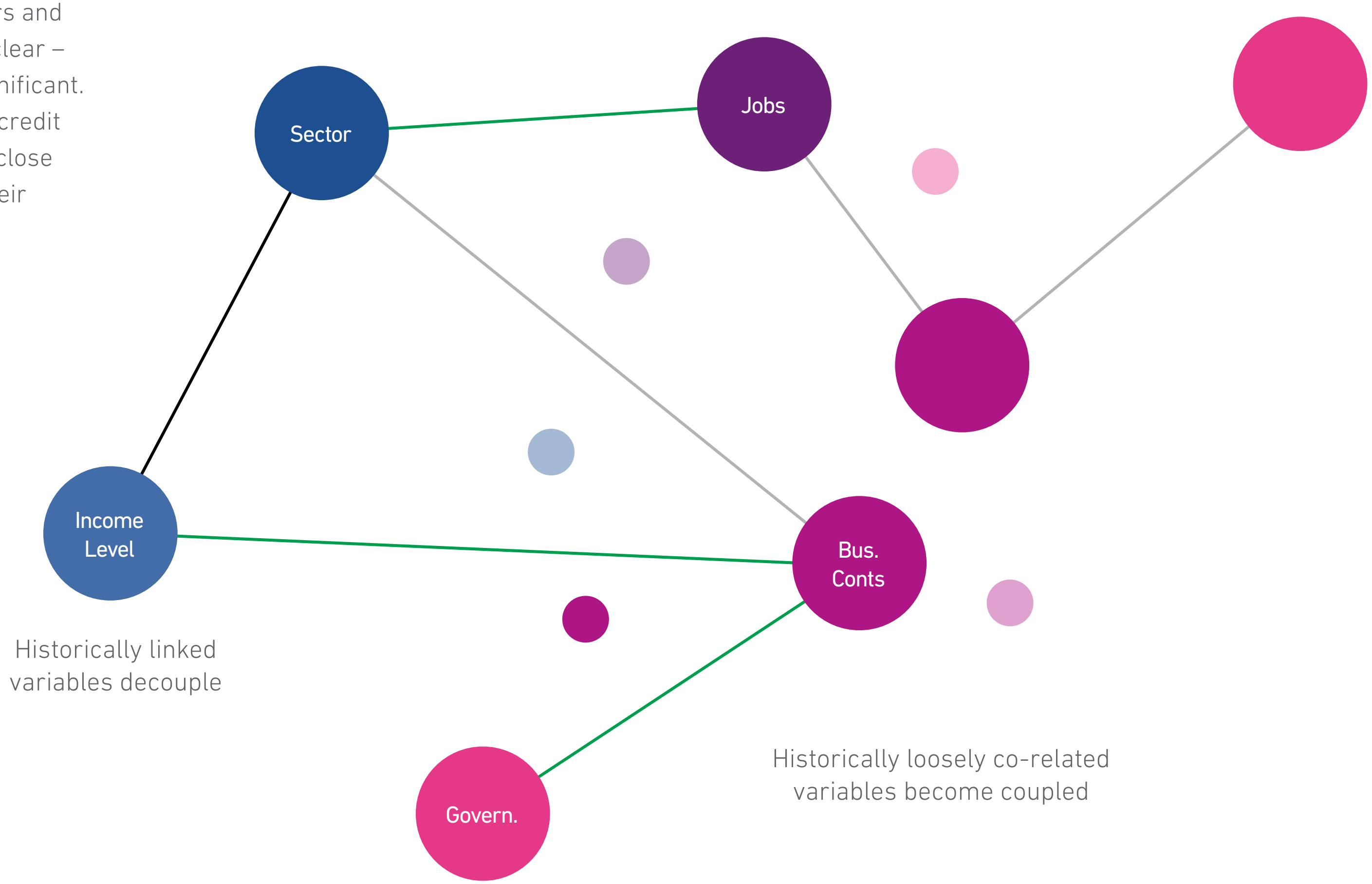
March 2020 Money Statistics, produced by The Money Charity.

Changes to portfolios due to rapid shifts in underlying borrowing characteristics

The COVID-19 pandemic will impact different sectors and geographies in different ways, but one thing looks clear – changes to consumer incomes will be swift and significant. It will therefore become increasingly important for credit providers to understand these rapid changes in as close to real time as possible, so they can protect both their customers and their loan portfolios.

We anticipate credit providers' performance will be impacted across a multitude of dimensions – account-related fees, changes to interest revenue, credit losses and higher expenses.

Changing correlations within scenarios and stress testing



Changing correlations need scenario testing with new data

However, these impacts will vary greatly by sector and customer segment, with the probability and impact of potential risks depending heavily on how the pandemic ultimately unfolds. We believe this presents credit providers with the following challenges in the coming weeks:

Identification:

Credit providers need to identify which customers are most at risk across industries and segments based on economic impact, then monitor this data for early warning signals. This data layer will also allow providers to iteratively build a fuller view of the 'during' and 'post' pandemic economic landscape.

Stress testing:

Whether they're determined by regulatory bodies or designed by credit providers themselves, current stress-testing techniques are based on scenarios from the pre–COVID world. However, the unprecedented scale of COVID-19 means providers now need to calibrate the outer limits of possible actions with new data to support their customers.

Scenario testing:

As credit providers work to mitigate the impact of COVID-19, scenarios led purely by macro-economics may no longer be successful. The scenarios created and tested in the coming weeks will need to be built around the spread of the virus. That means developing a range of possible scenarios based on its progression, the UK's regulatory response, shifting supply and demand, and how the virus affects different parts of the economy.

Increased stress on collections processes and a new picture of vulnerability

As the COVID-19 crisis intensifies, the stress on credit collections will become challenging, with both firms and customers experiencing unique problems:

- Rapid changes to millions of people's personal circumstances will make it difficult for credit providers to assess vulnerability and identify customers who need support.
- The ability to sustain operations as demand grows but resources reduce will cause significant internal challenges. For example, handling inbound calls, capturing income and expenditure details, identifying vulnerability etc. With limited IT resources, implementing new systems and approaches through APIs will also be challenging.

Vulnerability and persistent debt:

- As the pandemic spreads, a large number of people may exhibit signs of vulnerability. Credit providers will need to better understand and address the relationship between physical health and personal debt, with large numbers of people self-isolating and moving onto statutory sick pay. On top of this, indicators of vulnerability will change, as the tables below show:
- The new FCA regulations regarding persistent debt (credit line removal) have been postponed until October 2020 at the earliest. That means credit providers will need to support customers who meet the criteria without removing credit lines, increasing risk for their own businesses.
- With regulations changing frequently to protect consumers, reporting and customer identification will become more important for credit providers.

Pre-COVID-19 indicators

- Consumer spending without funds
- Increased or faster spending
- Excessive use of overdrafts
- High appetite for short-term borrowing
- Increased ATM withdrawals

Changes to indicators due to COVID-19

- Loss or reduction in personal / HH income
- Shift in spending to high-priority items
- New or unauthorised use of overdrafts
- New or increased appetite for high-cost loans
- Greater reliance on savings

Forbearance and interest moratoriums:

- Emergency payment holidays are being announced for consumers and businesses needing help. While helping the public, these payment holidays will freeze credit providers' borrowing data for weeks or months, leading to challenges in both credit reporting and evaluation.
- Processes designed to give people breathing space will experience high volume and come under increasing pressure. They'll need to be managed properly to make sure cases are followed up effectively and customers understand their obligations.
- Credit providers will also need to flag customers who are within moratorium periods and identify the impact of these moratoriums on the credit facility being used. This extra work will lead to significant increases in operational overheads.

Rising cases of first-party and third-party fraud

The correlation between financial vulnerability and fraud has long been reported as a challenge. In today's climate, with more people vulnerable, the likelihood of both first-and second-party fraud increasing is heightened.

One of the most pressing challenges facing fraud teams however isn't an increase in applications needing assessment, but the inability of staff to access systems from home, and resource constraints as people self-isolate and are off work with illness. Organised fraudsters are likely to take advantage of a perceived lack of readiness within banks and financial services in order to get some fraudulent applications through.

As the current situation continues, even those on 80% of their usual salary may see their finances stretched and need to resort to credit. Worsening financial situations will also push some consumers to be more more economical with the truth about their circumstances in order to obtain credit for which they would otherwise be refused. This trend was seen during the 2008 financial crisis. Last year we identified this trend in mortgage fraud, where we saw a sharp rise in first-party fraud – caused by people falsifying their income and expenditure to access mortgages. This was a result of an emerging strain of affordability, which today we see sharpened.

But this concern isn't limited to first party fraud. There's also an increased likelihood that desperate people will be induced into selling their ID or bank account for fraudulent use. This could manifest itself as increased ID fraud-related applications or money mule activities.

Reviewing how fraud referrals are prioritised will help to limit the impact of this behaviour. While applications might be in decline at the moment, they're poised to increase significantly over the coming months, so now is a prudent time to assess just how robust fraud processes really are.

As fewer people are visiting banks, more consumers will be turning to internet and phone banking for the first time. In some cases, this will leave them more exposed to standard bank account related scams, from phishing for login details to push payment frauds.

What's the likely impact on credit providers' new lending?

Falling numbers of new applications

As ever, it will be important for credit providers to assess affordability as part of the onboarding process. However, with the pressures of COVID-19 on consumers' incomes, it will be crucial to determine whether extending credit is affordable for the customer – not only now, but also over the coming months as the pandemic spreads and contracts. To accurately make these evaluations and inform better lending decisions, data will need to be gathered more frequently and at greater depth.

Newer, richer data will also help consumers understand not just what they're eligible for given their new circumstances, but also what's affordable. In turn, this will empower them with both choice and knowledge. It will enable them to access suitable products and prices, as well as building a better awareness of how new credit lines, or a product switch, will affect their overall financial health – which may be changing week by week.

A rapidly changing applicant mix, driven by disproportionate effects

It's well reported how employment models have changed over the last few years. Younger generations, as well as those new to the UK, are harnessing the gig economy to provide for their families or supplement their income. According to the ONS, 2.8 million people in the UK have worked in the gig economy in the last 12 months. Unfortunately, a large proportion of these workers are deemed as self employed or have zero-hour contracts, reducing their current rights.

Experian analysis shows that during the initial pandemic-shock stage, the most vulnerable consumers will pull away from the credit market (as evidenced by the improvement in Delphi scores across the new applicant mix - indicating retraction of borderline or vulnerable customers from the market). However, as the effect of the pandemic deepens, and we enter the economic-shock stage, we expect the overall profile of the applicant mix to deteriorate, with even those consumers who have never before struggled financially starting to face affordability challenges. Credit providers will need accurate, timely data and sector-specific insights so they can make the fast, fair credit decisions UK consumers need.

What KPIs should you be tracking?

The circumstances we find ourselves in are unparalleled and changing daily. The way we prepare to weather the impact in the short term will be key to making sure its long-term effects are contained as much as possible – both for the customers in our care and for our own businesses.

We know that data has the power to protect and preserve economies, and that by monitoring the relevant KPIs and taking the appropriate actions, we can all work to limit the pandemic's impact. As your partner, we're here to help you do just that, by offering you the best of our experience and expertise through our expert consultancy services and suite of relevant solutions.

Our initial analysis has highlighted the following five areas to watch:

#1

Declining levels of applications and credit quality

With a reduction in new applications for credit, it will be important to look to your existing base for growth. Existing customer management strategies will need to be re-evaluated to understand what changes can be made to balance extra customer support with acceptable risk.

It's likely we'll see a shift in lending types, with the demand for sub-prime credit growing and demand for prime credit reducing. Therefore, a review of your scorecard and segmentation, together with analysis of your cut-off criteria, can help to make sure you're accepting the right customers for your risk appetite, even in a reduced pool.

#2 A need to monitor affordability across the lifecycle

Understanding how consumers are being affected by the crisis is the key to proactively providing the help and care they need – both immediately and over the coming months.

As we've seen in this paper, the continuous monitoring of affordability will be critical not only for identifying stress, and therefore pre-delinquency, but also for protecting vulnerable consumers. Being able to perform affordability checks 'in-life' will bring the value of foresight. Applying this same level of care and attention to new lending will enable you to better understand consumers' affordability status and offer the right products, at the right time.

Experian's affordability solutions can bring you the technology and insight made possible by Open Banking. This includes categorised bank transaction data that can be used to understand the income and expenditure of an individual in real time. Armed with this information, you can proactively identify stress and pre-delinquency, support your customers and monitor the effect on your portfolio.

Even customers with historically good levels of affordability are entering new territory, with many seeing decreasing incomes either because they're self-employed or because they've been furloughed by businesses that can no longer operate. It will be important for you to help these people understand their new financial circumstances and what they're now eligible for.

#3 Deterioration of asset quality

Our analysis shows that in the current crisis, people who are already classed as vulnerable and financially stressed are likely to become more so. However, others who rely on businesses with poor cash reserves will also undergo stress – many at a level they've never experienced before. Along with a lack of savings to fall back on, this is likely to lead to a much more financially stressed society, with a growing number of at-risk and vulnerable consumers.

Data on the demographic profile of customers will allow for the creation of regional-level vulnerability and risk heatmaps, which can provide insight in terms of your most vulnerable postcodes and households. Combined with more frequent feeds of bureau data which alert you to changes in your customer's situation including insight about sudden changes to their income and any payment holidays they may have agreed, these can provide a richer view of the profile of your book.

#4 Changing portfolio dynamics

Inevitably, your credit portfolios will feel the impact of the virus, and having access to the very latest macro-economic trends will enable you to run more accurate stress testing and gain a clearer picture of what that impact is likely to be.

Due to the rapidly evolving impact of the crisis, scenario models that have worked in the past are unlikely to be relevant today. A new response is needed and at Experian we can support you in developing appropriate, effective models. These will consider the different variables in play, the progression of the pandemic, regulatory change and new shifts in supply and demand.

It's also fair to say that the assumptions made when calculating expected credit loss as part of IFRS9 will need to be rethought based on the latest insights to make sure that they're accurate and robust. Again, we're here to guide you through this process, with expert advice and practical tools.

#5 Increased pressure on collections processes

Lenders are working hard to proactively help consumers, but it's inevitable that many people will fall into the collections process, putting stress on its existing resources.

While the volume of consumers pulled into the process will increase, the immediacy of their needs will be no less. It will, therefore, be immensely challenging to serve them fast enough, especially if the number of underwriters available to make manual decisions reduces further due to illness.

Automating current manual processes could help to alleviate this challenge, especially when combined with more regular feeds of data from the bureau, and access to consumers' own consented data through Open Banking. Together, these factors can help you base lending decisions on the best available data, in these rapidly changing times.

Strategies and collections scorecards that were applicable before the crisis may need to be recalibrated, and with a potentially reduced number of employees available to take and make calls, other digital ways of communication may need to be sought. Once more, our teams are ready to discuss, advise and help you put effective systems in place.

#6 Increasing cases of fraud

Both first-party and third-party fraud are likely to increase over the coming weeks and months as people try to navigate the unstable economy and job landscape.

In the case of first-party fraud, there's increased potential for individuals to be tempted to commit fraud as their financial circumstances change. Checking against known fraud data may help you avoid increasing credit limits if you believe there's a risk the person won't be able to repay.

Fraudsters are fast, unrelenting, indiscriminate, inventive and opportunistic, so there's also an increased risk of more people falling victim to third-party fraud. Right now, it's important to conduct fraud account monitoring against known fraud data, allowing you to not only identify ongoing fraud risks within your existing customer base but highlight fraudulent new applications.

Here to help you get through this

If you'd like to discuss any aspect of this report, or find out more about how we can support you through this crisis, please get in touch with your Experian account manager today.

While the road ahead may be rocky, and there will be new developments to navigate, we believe that by working together, and bringing you powerful data and tools, we can help you and your customers come back from this crisis strong, secure and ready for a brighter future.

Visit our website for more information on how we can help:
www.experian.co.uk/business

Or contact us:
Business.Enquiries@uk.experian.com

Stay up to date with our latest thinking,
by bookmarking our thought leadership portal:
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The insight contained within this report is prepared using research performed on both Experian data and external data sources, in addition to market research. All sources, unless referenced, are from Experian insight.

The information contained within this report is designed to help businesses manage the complexity brought by a national crisis - and is a summary of key areas and capabilities. To understand more about the breadth of market-leading capability Experian has, or to access further detail on the impact of Covid-19 on consumers, business and lending portfolios - please contact us.

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