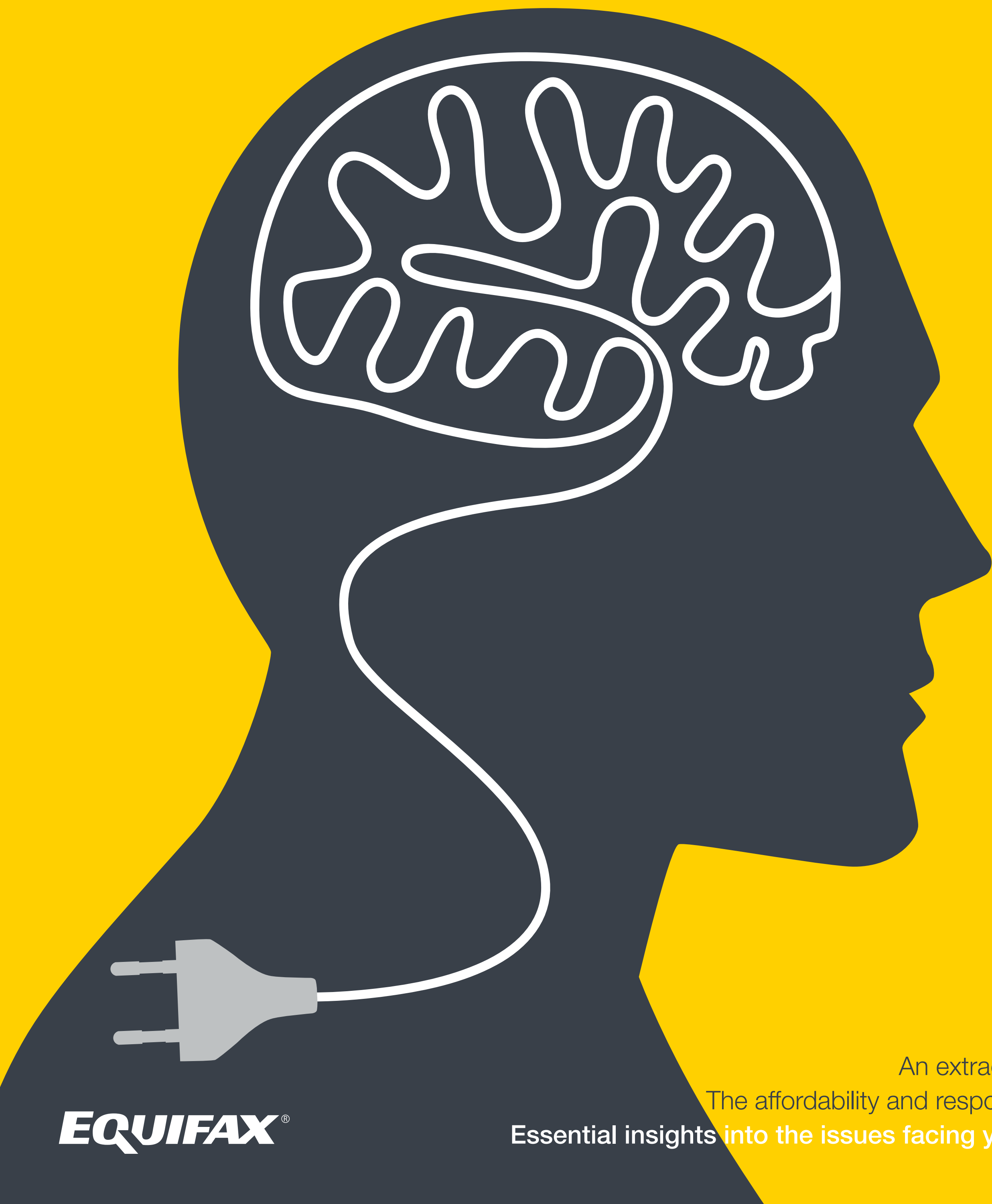
KNOWLEDGE IS POWER

HOW AFFORDABILITY ASSESSMENTS CAN BENEFIT BOTH LENDERS AND CONSUMERS



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An extract from Perspective:
The affordability and responsible lending issue
Essential insights into the issues facing your industry today

__Laura Hales, Product Manager – Scoring and Intelligence at Equifax,__ explores how different kinds of affordability measurements are changing the future of borrowing, and lending, for the better.

With the amount of regulation still growing in the lending space, questions continue to be asked around how these new checks will affect consumers. One of the key areas of focus for the past few years has been affordability and ensuring customers are given products that are right for them.

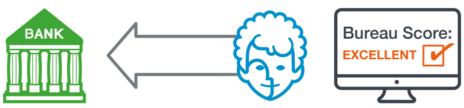
What is required by regulators and why?

Regulators require a proportionate assessment of affordability to ensure that the offered credit product is right for the consumer. The FCA rules also state that lenders must not allow a customer to take on debt that they will not be able to repay without suffering other hardships – such as needing to take on additional credit, or having to re-mortgage their property.

Affordability checks are now in place with lenders at varying levels of complexity. These checks should ensure that the borrower has a good credit history, and also that they can meet repayments of any proposed debt.

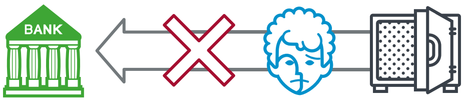
As a simple example:

Jim has had many credit products over the past few years and never missed a payment. He looks like a great candidate for credit.



Jim applies for a £10,000 loan over two years, which has repayments of around £400 per month. With a check based purely on his credit score, a lender may accept the application.

However, what if we knew that his salary is around £600 per month? With access to this information, the same lender may no longer feel that the £400 repayment is manageable. Lending in this case would be higher risk and not in the best interest of the borrower.



But doesn't this reduce lending? That doesn't sound too great for consumers.

Well, in some cases lending is not appropriate and will be detrimental to the consumer in the long run as they may face difficulties in meeting their financial commitments. However, in other cases, affordability checks can actually improve the chances of a consumer gaining access to credit.

A great focus on enhanced affordability checks mean that lenders are now able to access a wider range of data sources, such as Current Account Turnover (CATO) data, property valuations, rental payments data and more to come. This enables a more comprehensive view of customers and their circumstances, and can help build up the profile of those who may have a 'thin file'.

What is a thin file?

A **thin file** is a term applied to **consumers who have limited credit data**. These may be younger people who have previously been too young to apply for credit, those new to the country (cross-border credit data sharing is not common in the industry) or people who simply have limited need for credit. These customers can struggle to gain credit, as their ability to repay, often based on past performance, is unknown. And unknown is a risk!

So how does the new data work?

Here are a few scenarios to show you how and where the data can be used.

New to country

Cross-border data sharing is rare, particularly for credit repayment data. This means that an individual, who has previously had a clean credit history and an excellent credit score in one country, may emigrate to a new country and find themselves struggling to be accepted for credit. How do we lend to these people?

Example:

John and his family have recently moved to the UK for work, from their home in Australia. John has no credit history in the UK, so even though he always made his payments back in Australia, he will struggle to get credit in his new home.

Let's say he applies for a new mobile phone contract in the UK. He may be declined due to a lack of credit history.

So what can we do to help John?

Using current account data (this data was made available in the last few years), we can see a minimum of £2,000 going through John's current account every month. This high level view of an individual's current account turnover, balances and limits enables lenders to properly assess their customers.

It would be clear, using this data, that John would be able to afford the debt in question despite his lack of UK credit history.

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Limited need for credit

Another group of people who may benefit from this additional data are those who rarely use credit. For example, my parents applied for a credit card for their holiday last year and it never occurred to them they might struggle to have their card application accepted, as they've never had bad credit. They'd only ever had a mortgage, which has been paid off for years. Some lenders who only use traditional credit information would draw a blank when assessing these types of consumers. However, a data source such as Property Valuation information could help.

Here's another example: we know that Michael and Sue live in a six-bedroom house, currently worth £500,000.

They would need to earn a sufficient amount to fund living in a property such as this, and they also are likely to have built up substantial equity, should they need it. Given this information, we would expect that a credit card repayment wouldn't be a problem for this couple, and approving the application is appropriate in this case.

New to credit

Young people, having been too young to apply for credit previously, or maybe lived at home with no need for credit, can struggle to get credit due to lack of credit history. They might be great payers but with no history to prove it yet. So how can we assess them?

Take an example. Maryam has just turned 19 and wants to get a loan to buy a car. She has never had her own credit before, as her mobile phone contract was in her dad's name, and she still lives at home. Maryam has a good job and has money left in her current account every month, but, with no credit history, she may struggle to get a loan.

In this case, we could use some of the data sources already covered in the previous two examples. But let's look to the future.

Open Banking and Payment Services Directive 2 (PSD2) are hot topics in the financial space at the moment and will make access to personal data easier. They will allow consumers to use their own current account transactional data as their 'passport' to credit. It will all be done online, so there will be no need to print off and post statements.

Let's assume the following transactions are seen on Maryam's current account.

Date	Transaction	Amount	Balance
01/05/2017	Salary	+ 1500	**3559 CR**
03/05/2017	Supermarket	- 48	**3411 CR**
12/05/2017	Rent transfer to Dad	- 200	**3211 CR**
24/05/2017	Restaurant	- 60	**3151 CR**
...	...	...	**...**
...	...	...	**...**
01/07/2017	Salary	+ 1500	**4325 CR**

She clearly lives within her means and maintains a healthy and increasing balance. Using this type of data, Maryam would be able to prove her financial worth. We can see her salary level, and we can see that she is managing her finances well. Seeing this information could help Maryam secure the loan she needs.

What is PSD2?

Payment Services Directive 2 (PSD2) is a European-wide regulation, which brings huge changes to the financial space. The main focus of the regulation is to bring new players into the payments market. The theory is that more competition will lead to more choice and better outcomes for consumers.

One key element of this regulation involves access to your personal current account data. These changes mean that the current account provider has to open up your data for access by other providers through an online link (but only with your permission of course).

These other providers could be offering better and tailored financial products, investment opportunities and more, by using your data to understand you in more detail.

But the key point to remember is that **you control who has access to your data**.

So how many people could this affect?

Recent analysis undertaken by Equifax found that more consumers are likely to benefit from affordability checks adding to their credit history, than those who will lose out because of it.

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This example looks at a set of around one million loan applications made in the first half of 2015. We looked at the following customer-level performance and their corresponding Risk Navigator score to categorise these applicants as low, medium and high bad-rate (NB These results are simplified for ease of explanation).

RISK NAVIGATOR BAND	Total
1 (high risk)	344,544
2	
3	
4	447,024
5	
6	
7	
8	343,899
9	
10 (low risk)	

High bad rate Medium bad rate Low bad rate

Let's say a lender would only accept applicants in the 'Low bad rate' category, which corresponds to a risk score in Band 8 or above. This would give you around 343,000 'accepts', with a corresponding customer-level bad rate of 0.45%.

This method works well for lenders and has done for some time, but the more information we have, the more accurate we can become.

Let's split these customers out by the Equifax Affordability Index, which is built to predict those with Low, Medium and High Affordability – based on their current account turnover, balance and limits.

RISK NAVIGATOR BAND	Affordability Index		
	Low	Med	High
1 (high risk)			
2		326,269	
3			
4			
5			
6		413,988	
7			41,311
8			
9	9,683	334,216	
10 (low risk)			

High bad rate Medium bad rate Low bad rate

This new method highlights two areas to swap in and swap out of the 'accept' pool. Around 9,000 accounts would move out of the 'accept' pot as they are now classified as a medium risk and 41,000 would move in as they are now classified as a medium risk. This would increase the number of accepted applications up to 375,000 accounts (an increase of 9.3%) and reduce the bad rate down to an overall 0.42% (a reduction of around 7% in total).

This example of adding in new affordability (CATO) data has been over-simplified – a lender would never make a decision on one score alone. However, it does prove the power of these new data sources, and that more consumers can be accepted for credit while at the same time a lender could see a reduced bad rate. Win-win!

Idea in brief

THE SITUATION

New and different kinds of affordability checks are changing the future of borrowing, and lending.

THE CHALLENGE

A credit score alone is not enough to assess affordability and ensure that customers are selecting products that are right for them.

THE TAKE AWAY

Knowledge is power.
New data sources, can help lenders understand applicants' financial situation better. This could result in more consumers being accepted for credit and the lender could see a reduced bad rate.

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