White Paper

Squeezed disposable incomes and the affordability challenge

Will North
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Ideas Vision Intelligence Success Development

Will is responsible for Callcredit's core credit reporting products and for market and proposition development across a range of sectors.

He has over 15 years experience in the credit industry and joined Callcredit from Jaywing where his responsibilities included Analytics, Strategy and Implementation, Consultancy, Sales, Client Management and Product and Proposition Development.

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1. Introduction

The continuing and unprecedented reduction in disposable incomes is now a major concern for lenders

As disposable incomes have continued to tighten the real impact on bad debts and profits has overtaken regulation as the main reason to assess affordability

Our recent white paper, 'The Increasing Value of Data in Credit Risk Management' began to explore the impacts of the economic climate, the regulatory environment and other market conditions. All are having major impacts on lenders and on their risk management approach.

Since 2009 many mainstream lenders have actually been subject to relatively benign external conditions due to historically low base rates and relatively small increases in unemployment. The impact of tighter lending policies and a more conservative approach from consumers has also contributed to a marked reduction in bad debt across much of the industry.

However, unemployment increases are now accelerating and the unprecedented reduction in the disposable incomes of those still in work that we have seen over the last 18 months is now a major concern for lenders.

Callcredit has been working on providing better indebtedness and affordability measures since the launch of the Over-Indebtedness Initiative (OII) in 2005. The initial focus was on helping lenders identify over-indebted consumers. However, although indebtedness levels remain high the recent squeeze on disposable incomes has clearly broadened the affordability challenge. Many more individuals are struggling to make ends meet regardless of their levels of indebtedness.

Over recent years regulation has perhaps provided the main impetus for many lenders to look beyond standard risk measures and address affordability and indebtedness issues. However, as disposable incomes have continued to tighten the very real impact on bad debts and profits has overtaken regulation as the main reason to assess affordability.

This paper investigates the various factors that are combining to hit consumers' spending power and their ability to meet their credit repayments. We then revisit the various regulations that continue to require and encourage lenders to ensure they assess affordability.

Finally, we discuss the impacts on lenders and go on to explore some of the options available to help lenders keep track of consumers' affordability, assess the potential impacts on their portfolios and discuss the latest innovations and best practice.

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2. Impacts on Disposable Incomes

Since 2009 many mainstream lenders have actually been subject to relatively benign external conditions due to historically low base rates and relatively small increases in unemployment

2.1 Current situation

Various factors have combined over the last few years to create downward pressure on disposable incomes.

However, the fact that base rates have remained at record low levels for the last 3 years has provided a significant positive impact on conditions for many homeowners. This has counteracted many of the negative factors impacting disposable incomes, but more consumers are beginning to suffer as ongoing inflationary pressures really begin to bite.

Overall, there is plenty of evidence that the majority of households are experiencing significant reductions in their disposable incomes. The Bank of England has published the results of a recent survey showing the % of consumers experiencing reductions in disposable incomes, split by residential status.

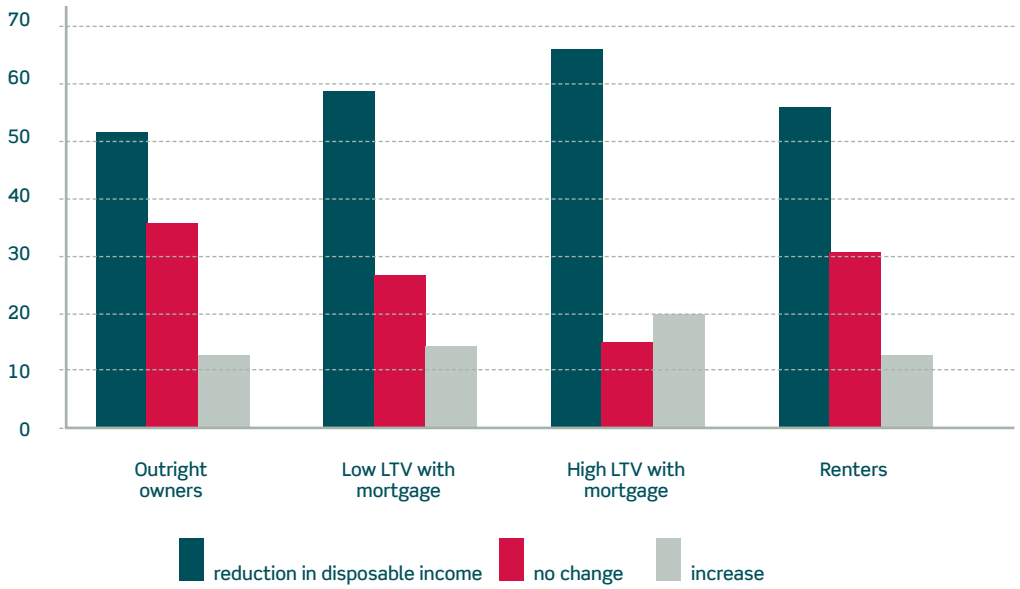

Figure 1, Changes in Disposable Income
Source – BoE Quarterly Bulletin

It is clear that the majority of consumers believe their disposable incomes are being significantly eroded and that this picture is true for outright owners, those with mortgages and those renting their home.

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Those spending the highest percentage of their incomes on essential goods and services are those most affected by recent inflation

2.1.1 High inflation

Inflation has remained well in excess of the Bank of England's target over the last few years, with measures typically running at around 5%. Not all prices have risen uniformly, of course, with some goods and services reducing in price while others have been rising at significantly higher than the overall rate of inflation.

Some of the highest price rises in recent years have been on essentials such as food, domestic utility bills and transport costs. The following chart illustrates the extent of these disparities in recent months:-

In addition, household rents have also risen at or above the rate of inflation in many areas. In contrast, mortgage costs have remained low due to continued low interest rates and many luxury goods have reduced in price.

Those spending the highest percentage of their incomes on essential goods and services will be most affected by recent trends in inflation. In other words, the biggest impact is on those who can least afford it.

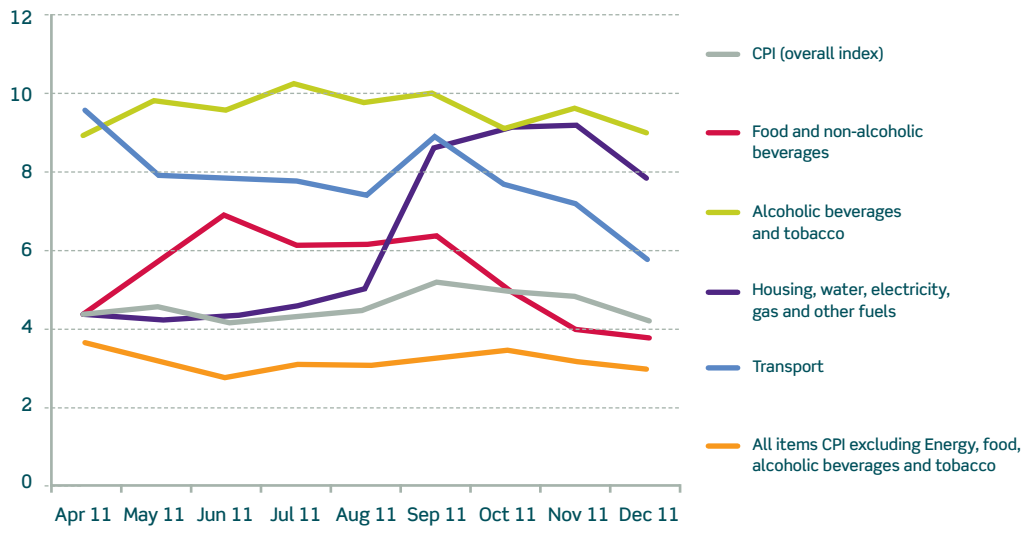

Figure 2, varying levels of annual inflation for different goods and services (source ONS)

Inflation levels have consistently exceeded wage growth in recent months

2.1.2 Lower wage growth

If incomes were rising by more than inflation then price rises would not necessarily have that much of an impact, but inflation is currently comfortably outstripping the overall level of wage growth in the UK.

Salaries are frozen across the public sector. Many private sector salaries have been fixed for some years now, although the situation is clearly more mixed in the private sector with some sectors and individual companies doing far better than others.

However, many people are struggling with reduced income due to a variety of factors such as a lack of over-time, little or no bonuses and reduced hours.

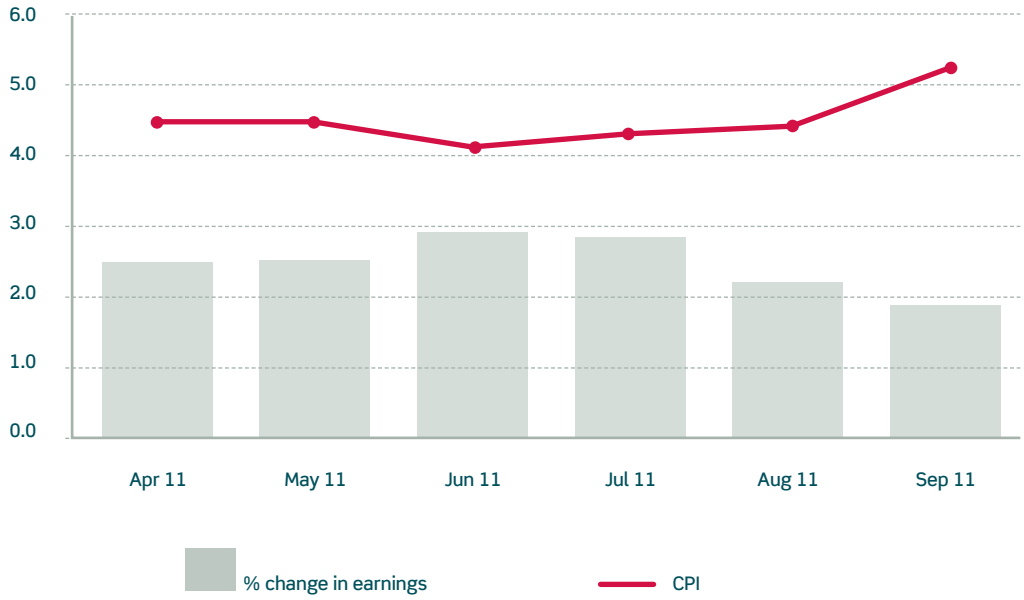

Figure 3, average earnings growth and inflation (source ONS)

As is clear from this chart, the average annual change in earning has been running at around 2% in recent months while inflation, as measured by the CPI, has been closer to 5%

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Reduced disposable incomes are being compounded for many by reductions in benefits

2.1.3 Benefit reductions

Reduced disposable incomes are being compounded for many by reductions in benefits, such as housing benefit and tax credits.

As of April 2012 families with a household income in excess of £26,000 will see reductions in their eligibility for tax credits. Currently, those with incomes up to £41,300 are eligible. Furthermore, households can currently qualify if one member works at least 16 hours a week. This threshold is due to rise to 24 hours per week from April 2012.

Although initial plans to remove child benefit for households with one member earning in excess of £42,475 as of January 2013 appear to be under review it is certain that changes will be made that reduce child benefit for many households.

A range of changes to Housing Benefit are also planned. The first phase of these will begin to impact existing claimants as of January 2012 and will begin to reduce the amount of benefits available. These changes will also tend to impact some of those struggling most in the face of stagnant incomes and rising prices.

Monthly unsecured lending payments have increased for many at the time when they can least afford it

2.1.4 Increased burden of unsecured debt

Furthermore, there is some evidence that the cost of servicing some forms of unsecured credit has increased.

While some good deals remain for the least risky consumers many have seen the interest rates on their credit and store cards, personal loans and other unsecured products rise significantly over the last couple of years.

Monthly payments on structured lending products may have increased for many at the time when they can least afford it. Although minimum payments have not typically altered on revolving products, the higher interest rates will have increased levels of overall indebtedness.

Whilst more affluent consumers have tended to pay down their debts in recent years, this clearly hasn't been an option for those struggling to make ends meet.

2.1.5 Unemployment

Unemployment levels are now increasing, following a period of stagnation, as public sector redundancies start to take effect.

Redundancies clearly have a major direct impact on defaults, but there are indirect impacts too. Redundancies also impact the economy and the disposable income of those still in employment through the impact they have on the demand for goods and services.

The UK is facing a long, slow and fragile economic recovery

2.2 Outlook

There is a general consensus that the UK, along with much of the western world, is going to have to continue to deal with a long, slow and fragile economic recovery.

Both consumer spending and confidence remain subdued. There is plenty of evidence from the high street that consumers are unable and/or reluctant to spend as many well established retailing names are closing stores or disappearing altogether. There appears little short-term prospect of an upturn in retail sales as a number of different factors combine to have a detrimental impact on consumer's spending power.

The sovereign debt crisis in the Eurozone is creating a massive amount of uncertainty that is further impacting both business and consumer confidence

Furthermore, the ongoing sovereign debt crisis in the Eurozone is creating a massive amount of uncertainty that is further impacting both business and consumer confidence. Confidence is essential for economic growth. Businesses and consumers are tending to delay investment decisions, including hiring new employees, and put off significant purchases. These decisions will further hamper any prospect of significant economic growth in the near future.

The current position clearly does little to help breathe life into a stagnant housing market and a volatile stock market, both of which further compound the problem and leave the majority of consumers less likely to borrow and spend.

The situation may well get significantly worse before we see a concerted, sustainable recovery. The unprecedented levels of debt in the UK and most other western economies are certain to hamper growth for many years to come. Even when economic growth finally picks up there is likely to be a further delay before this feeds through into significant growth in real incomes and improved affordability for consumers.

3. Government and Regulation

More regulatory attention on affordability and income verification is likely over the coming years

In the past regulation has provided the main impetus for many lenders to look beyond standard risk measures and assess affordability and indebtedness.

Many lenders are now looking beyond regulation to the real financial benefits of affordability assessment. However, regulations are still relevant and we are likely to see more legislation over the coming years.

FSA Mortgage Market Review	Proposes affordability assessment must be a requirement for mortgage lending with income and expenditure verification where possible
OFT Irresponsible Lending Guidance	Affordability must be fully assessed in each and every case
The Consumer Credit (EU Directive) Regulations 2010	Includes changes to the assessment of creditworthiness required before granting credit
Treating Customers Fairly (TCF) and the Lending Code	Covers the need for assessing ability to repay

Figure 4, Four key initiatives remain important in the regulation of affordability criteria, indebtedness and income verification

Lenders are certain to have to do a more robust assessment of affordability for all applicants in future

3.1 FSA Mortgage Market Review

The FSA issued its consultation paper entitled 'Mortgage Market Review: Proposed package of reforms' in December 2011. There is a major focus on affordability in the reforms proposed here, with the following three principles at the core of the FSA's vision of good practice in mortgage assessment:-

- Mortgages and loans should only be advanced where there is a reasonable expectation that the customer can repay without relying on uncertain future house price rises. Lenders should assess affordability.
- This affordability assessment should allow for the possibility that interest rates might rise in future: borrowers should not enter contracts which are only affordable on the assumption that low initial interest rates will last forever.
- Interest-only mortgages should be assessed on a repayment basis unless there is a believable strategy for repaying out of capital resources that do not rely on the assumption that house prices will rise.

Lenders are almost certain to have to undertake a more robust assessment of affordability for all applicants in future, taking into account verified income measures as well as expenditure commitments and indebtedness.

The need to incorporate affordability metrics such as changes in interest rates into stress testing is also a key recommendation.

3.2 OFT Irresponsible Lending Guidance

Before granting or increasing a credit facility, a lender must make a proper assessment of the consumer's ability to repay it by:-

- Reviewing documentary evidence of income and expenditure
- Or ensuring the information used is strong enough to make a "proper assessment"

The OFT expects lenders to be complying with its demands already, but compliance is often achieved through manual processes that are labour intensive and expensive.

3.3 EU Consumer Credit Directive

Adopted by the European Council in May 2008, the legislation implementing its provisions came fully into force on 1st Feb 2011.

Creditors are required to assess the borrower's creditworthiness before granting credit or significantly increasing the amount of credit.

The assessment must be based on sufficient information, obtained from the borrower where appropriate, and from a credit reference agency (CRA) where necessary.

3.4 Treating Customers Fairly and the Lending Code

Treating Customers Fairly (TCF) guidelines are now well established across the financial services industry.

These regulations make it clear that a reasonable assessment should be made to ensure that a customer's ability to repay is confirmed.

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4. Impacts on Lenders

Some groups remain affluent and confident and represent an opportunity for mainstream lenders to engage in profitable business

Viewing the entire population as struggling in the face of deteriorating affordability is of course both inaccurate and a greatly over-simplified view of the current situation.

There are many different segments in society, some of whom remain affluent and confident and still present an opportunity for mainstream lenders to engage in profitable business. Even some higher-risk groups can be profitably lent to, of course, as long as the lending assessment is thorough and the interest rate set appropriately.

Although many consumers have been paying down their borrowing over the last few years, those with affordability issues have obviously not had this option available to them. Indebtedness levels remain very high by historic standards and lenders should be extremely cautious about the potential impacts of a further deterioration in affordability on many consumers ability to continue to meet their debt repayments.

Renters are typically more in danger than owner-occupiers while interest rates remain low and rents continue to rise

4.1 Increased numbers unable to keep up with their repayments

A significant number of borrowers will be pushed into the position of having a negative disposable income as the cost of living continues to increase. It is inevitable that many of them will begin to miss payments and default.

Those with relatively modest incomes are more susceptible to price rises, with those coping with reduced incomes from benefit reductions also more at risk. Renters are more in danger than owner-occupiers while interest rates remain low and the barriers to entry into the housing market keep demand for rented accommodation high.

4.2 Forbearance

Large numbers of individuals with uncertain long-term prospects of being able to repay their debts are currently in forbearance strategies. At some stage many of these consumers will have to be allowed to wash through. Lenders will have to deal with the impact on their bad debt figures and the knock-on impacts on the economy of an increase in mortgage repossessions.

Mainstream lenders are also increasingly finding that their customers are turning to convenient, high-priced, short-term lending options

4.3 Short-Term Lending

Mainstream lenders are also increasingly finding that their customers are turning to convenient, short-term lending options.

Short-Term Lenders have transformed the market in recent years by offering convenient loans, typically as a single-repayment advance against income.

Mainstream lenders need to do more to understand which of their customers are applying for advances against their income, what value and number of loans they take out and how this is impacting on their mainstream lending products.

4.4 Unemployment

Both default rates and the average cost of each bad account will increase and combine to increase overall losses

Unemployment has begun to increase as public sector cuts begin to take effect and the lack of consumer and business confidence intensifies in the wake of the ongoing Eurozone sovereign debt crisis.

Many more public sector redundancies are expected over the next few years. There will be knock-on impacts on the private sector through both the supply chain to the public sector and the impact of reduced consumer demand due to the impact of redundancies on consumer spending.

The fragile economic position in the Eurozone due to the sovereign debt crisis and the prospect of a further worldwide recession may well result in significantly more private sector redundancies too.

4.5 Reduced recovery rates

Reduced affordability also has an impact on recovery rates as it becomes harder and more costly to collect arrears from those borrowers who have defaulted on their loans.

So, both default rates and the average cost of each bad account will increase and combine to increase overall losses.

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5. What can Lenders do?

Manual options can be costly both in terms of operational expenditure and the impacts on sales of introducing a more cumbersome application process

5.1 More discrimination and smarter decisions

Responsible lending cannot be achieved without looking at individuals' incomes and checking their indebtedness and affordability. Equally, a robust and complete assessment of credit risk is increasingly difficult without including affordability.

5.1.1 More thorough manual assessment

Lenders can react to the current affordability challenge by increasing the level of manual underwriting and introducing processes that require the applicant to provide documentary evidence of their income.

A more thorough review of expenditure from a detailed application form and subsequent manual questioning is also an option, as is the provision of bank statements to allow an assessment of affordability from their current account behaviour.

Discriminate between consumers with similar debts based on whether they are paying down their balances or increasing their overall indebtedness

However, these options can be costly both in terms of operational expenditure and in the impacts on sales of introducing a cumbersome application process. Another drawback of relying on manual assessment is the lack of consistency in decisions.

Current account providers have a major advantage where they hold the main banking relationship and receive a salary into their account. However, other lenders don't have this option and current account providers often have to deal with requests from those whose main account is elsewhere.

5.1.2 Time-series indebtedness trends

A detailed view of each consumer's borrowing over time is now readily available. A range of metrics looking at accounts, balances and payments over various time periods provide important additional insight into behaviour.

It is possible to discriminate between consumers with similar debts based on whether they are paying down their balances or increasing their overall indebtedness.

This information has been proven to provide significant additional discriminatory power in assessing credit risk.

Indebtedness and affordability measures are increasingly vital in providing the level of insight necessary for effective risk assessment throughout the credit cycle

5.1.3 Data-driven affordability assessment

Data-driven measures of affordability are also now available. Many organisations now share application income data and current account credit turnover to aid with the assessment of affordability. When used in conjunction with traditional credit scoring such an approach enables a complete risk assessment package. Indebtedness and affordability measures are increasingly vital in providing the level of insight necessary for effective risk assessment throughout the credit cycle. Over the last few years some major lenders have invested in integrating a range of affordability assessment tools into their credit management processes.

Affordability assessment is also important to recognise those who remain affluent

These include:-

- Validating income at the point of application
- Using a range of data to inform about the indebtedness and affordability of applicants and customers
- Monitoring portfolios to identify those who are most overindebted
- Incorporating affordability metrics in to stress-testing, adding an important new dimension to understanding the potential future risks associated with lending books
- Reviewing the ability to repay as part of collections and recoveries strategies
- Tracking those individuals who are most susceptible to an increase in mortgage rates

Identifying those with affordability issues is crucial, certainly, but it's also important to recognise those who remain affluent. It isn't always possible to differentiate just using traditional credit scoring, so affordability measures are required to ensure an accurate risk assessment can be made.

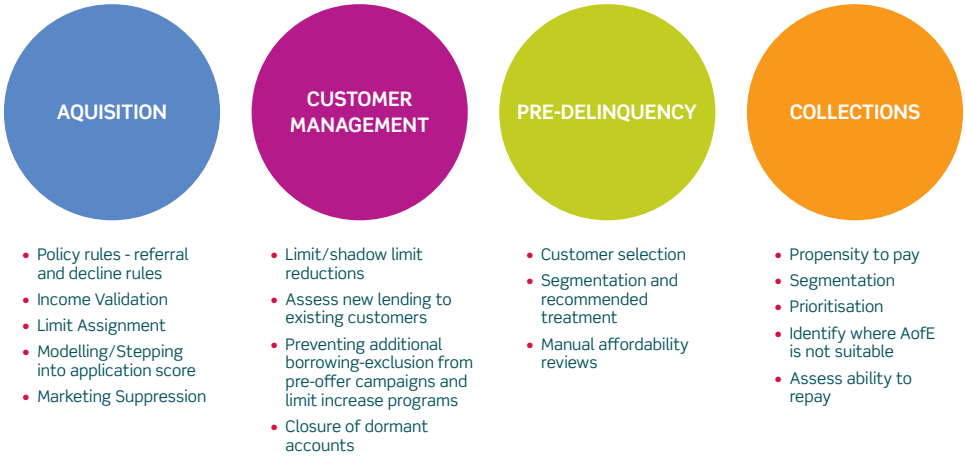

Figure 5. Uses of affordability data through the credit lifecycle

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5.1.4 Swap-sets with credit risk

As well as spotting those with little or no affordability, measures can be used to identify positive swap-sets of marginal risk declines.

These groups strong affordability position can actually result in them being a significantly lower overall risk. This information can therefore result in these cases being accepted where they were previously declined or a more appropriate interest rate being applied.

Most individuals will hide financial difficulties from their creditors

5.2 Tracking significant events

Lenders also need to consider keeping track of certain key metrics and monitoring for events, both internal and external, that suggest deterioration in a customer's affordability.

Most individuals will hide financial difficulties from their creditors. A range of internal data, from cancelled direct debit mandates, credit card cash withdrawals and short-term lending or pawnbroker credits can provide lenders with additional insight into which customers are struggling to make ends meet.

Analysis of specific transactions can also provide important additional insight too. Changes in spending patterns such as moving supermarkets or reductions in the value of fuel transactions can indicate a decline in affordability.

There is also a wealth of external data available to lenders. Daily triggers are available to provide lenders with fast and accurate alerts concerning significant new borrowing and missed payments.

Indebtedness, income and affordability metrics present an opportunity to significantly enhance forecasts of the impact on consumer behaviour of changing economic conditions

An accurate view of disposable income levels helps organisations to agree mutual acceptable and sustainable outcomes

5.3 Stress Testing

Lenders also face the challenge of understanding the impacts of affordability issues on their portfolios, including forecasting and incorporating affordability metrics into stress testing.

Indebtedness, income and affordability metrics present an opportunity to significantly enhance forecasts of the impact on consumer behaviour of changing economic conditions.

Traditional models rely on historic data and are based around a Markov chain approach. They can therefore fail to capture a build up in vulnerabilities within the market.

Individual stresses can be considered in isolation but a more realistic picture emerges when stress scenarios are combined. This can be completed on a 'waterfall' basis where different scenarios are layered, one on top of another. This can be used to identify pinch points in portfolios which are particularly susceptible to economic deterioration.

The following areas can be stressed based on a range of credit risk, affordability, macro-economic and geo-demographic indicators:-

- Income Levels
- Debt Repayments
- Interest Rates
- Cost of Living
- Equity Levels

Various stress levels can be applied to different customer groups based on geographical region or demographic groupings. More flexible models are required so that numerous stresses can be applied and new scenarios modelled without the need for a rebuild.

Organisations need a complex level of scenarios to be tested so that the portfolios are twisted every which way and weak spots identified.

5.4 Collections

A thorough assessment of affordability also has a range of possible uses in collections, ranging from pre-delinquency selection and segmentation through to assessing the ability to pay in recoveries.

Affordability scores and metrics can improve propensity to pay models and collections strategies, help improve prioritisation and even help with very specific decisions such as the suitability of seeking an attachment of earnings.

Recoveries has always been about understanding an individual's level of disposable income and agreeing a sustainable way forward. Until now, this assessment has mainly been provided by the customer and was often difficult to validate.

Financial assessment practices such as the traditional common financial statement are being heavily enforced by the Lending Standards Board for those cases which claim to be in financial difficulties.

Having a clear line of sight of disposable income levels by validating income, credit and household expenditure enables the collecting organisation to agree a mutual acceptable and sustainable outcome.

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6. Conclusions

The current squeeze on disposable incomes has had a huge impact on living standards and created unparalleled pressure on household finances. Furthermore, with the UK set for a long and fragile economic recovery the situation is going to deteriorate further before we see any improvement.

Affordability measures are therefore increasingly vital in providing the level of insight necessary for effective risk assessment throughout the credit cycle. It isn't always possible to differentiate just using traditional credit scoring, so affordability measures are required to ensure an accurate risk assessment can be made.

Over the last few years some major lenders have invested in integrating a range of affordability assessment tools into their credit management processes. It is imperative that other lenders follow suit if they are to compete in the years to come.

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To find out more about Callcredit's Credit Solutions
email **info@callcreditgroup.com** call **0845 60 60 609**
or visit **www.callcredit.co.uk**

For a specific enquiry relating to this White Paper, please contact:
Will North, Market Development Manager-Acquisition, **will.north@callcreditgroup.com**
Mick Ellender, Head Of Consultancy, **mick.ellender@callcreditgroup.com**

Callcredit Information Group
Enabling Smarter Decisions

About Callcredit Information Group

Callcredit Information Group has a leading edge approach to using consumer information in credit referencing, marketing services, interactive solutions and consultative analytics. This enables our clients to cost-effectively identify, engage and convert more new customers and optimise existing customer revenues.

Callcredit offers intelligent solutions across the customer lifecycle as follows:

- Plan
- Acquire
- Verify
- Manage
- Collect

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