Affordability

A Practical Guide For Lenders

DirectID

Introduction

It is now imperitive for banks to give due consideration to affordability assessments prior to making a credit risk decision. This has come about because of 2018 legislation from the FCA.

The rise of online loans, payday loans and High Cost, Short Term Credit (HCSTC) has been synonymous with today's hyper consumerised and globalised world.

The issue of whether loans are affordable for consumers or whether they should be offered to anyone who appears to be in a reasonable position to repay them has been debated at length by policy makers and regulators.

The debate around affordability came into even sharper focus following the demise of Wonga. The pay-day lender was ultimately brought to its knees by a deluge of complaints and compensation claims for not considering how loan affordability would impact upon the loanee.

Following an extensive consultation of affordability, credit worthiness and credit risk, the Financial Conduct Authority in 2018 took action.

From the end of 2018, lenders must consider loan affordability for all customers. This means that as well as calculating credit risk and the possibility that the loanee will not repay the loan, they must consider the financial health of the applicant, and how a loan will potentially impact this.

This is complex. While lenders can use Credit Reference Agencies to determine what loans, credit cards and other financial products an applicant has currently and historically, determining what the impact of a new financial product will have on an applicant remains challenging.

Within the contents of the eBook, we will cover:

Affordability in the UK

Credit History

Today when we talk of credit history we think of an individual's personal credit history. But "credit" itself has a long and complex history. The issuing of credit goes back to the earliest civilisations, dating back 5,000 years or more. By the time of the Romans, credit was well established. In the Middle Ages through to the later Victorian era, credit had become a complex creation, necessary for the functioning of relatively modern economies but beset with religious, political and cultural baggage.

The UK Loan Sector in 2020

Today the loan sector is a multi-billion pound enterprise.

- 58,000 financial services companies are authorised by the FCA
- £1.4 billion worth of mortgages approved in the UK in Q1 of 2018
- 3 million people use 'high cost credit' each year including rent-to-own and doorstep lending.2
- Total debt per UK household in December 2019 - £60,213
- Average credit card debt per UK household in December 2019 - £2,594
- According to the OBR's March 2019 forecast, household debt is forecast to reach £4.425 trillion in 2023/4

The payday loan sector comprises over 60,000 UK customers worth an estimated £220m. While the volume of lenders has decreased from its 2013 peak of 200, it is still made up of 40 to 50 major providers.

UK Indebtedness

According to a 2017 Standard & Poor report, UK consumer debt stood at £200 billion as of October 2017. S&P found this highly concerning. This is the same value of indebtedness as proceeded the Great Financial Crash of 2008. And while average earnings are increasing at around 3% (2018 figures), consumer credit is growing at closer to 10% per annum.

- Average debt per household, including mortgages, is £58,658
- Or an average of £30,636 per adult – around 113% of median income
- Based on July 2018 trends, the UK's total interest repayments on personal debt over a 12 month period would be £49,994 billion
- The average consumer credit borrowing stood at £4,099 per adult, up from £4,090 last month.

Continued.

High Cost Short Term Loans in the UK.

Why Do We Take Out Payday Loans?

As nearly ever UK adult will know, there are certain items that are almost impossible to buy without the extension of credit. The classic example would be a mortgage, or car. Many individuals on low incomes however are increasingly finding that payments made from the Exchequer (benefits), or income payments, are not covering the cost of everyday essentials.

Payday Loans

- Average loan size - £260
- Most common amount borrowed - £100
- 83% customers take out their loan online

What Was The Loan For?

- 52% said living expenses
- 10% said car or vehicle
- 7% said general shopping

Why Was The Loan Required?

- 52% said an unexpected increase in outgoings
- 15% said it was for household bills
- 59% said they took out the loan to pay for something they could not do without

Affordability

Addressing the issue of Affordability.

What Is It?

Affordability is the part of a credit application that concerns itself with the financial health of the consumer, rather than the risk to the lender of the loan not being repaid (credit risk).

Together affordability and credit risk are used to determine an applicant’s creditworthiness.

As we will discuss, a review of affordability was prompted following analysis of lending practices at certain providers of short-term credit, including the now defunct, Wonga.

As far back as 2011, the term affordability was used by the Office of Fair Trading (OFT) but only came to prominence after the Financial Conduct Authority (FCA) took control of regulating the financial sector.

As we can see from the previous page, while the sector has shrunk in size since 2014 when the FCA released its last batch of regulations (see page 4), the industry is still enormous. At the same time, statistics also reveal that many UK residents are using pay-day loans to cover essentials such as household bills.

The FCA has let it be known that irresponsible lending such as offering consumers credit they cannot reasonably be expected to repay is no longer acceptable.

How is it calculated?

Lenders therefore must take into consideration what may happen in their customer’s future – as far as they are able. They may ask themselves questions such as whether the applicant is likely to remain in the same job and at the same salary? Can the applicant still repay should there be a change in interest rates?

When offering credit, lenders now have a responsibility to obtain enough information from the consumer to ensure the applicant can afford to pay it back. This will usually involve asking questions of borrowers to ensure that they can afford repayments, backed up by information from their credit file.

New Regulations and the Impact of the FCA

Since taking control of regulating the UK's financial providers in 2011, the FCA has been clear that affordability is a key tenet for providing financial readiness to the credit system. This has been reflected in the FCA's business commitments which cite upholding transparency in the financial system as being key.

Limited interest

In 2014 the FCA made its first foray into regulating the HCSTC market. APR at this time was often routinely advertised within the thousands. Wonga offered loans at 5,800%, and allowed customers to "roll-over" loans.

The new rules limited the amount of interest that could be applied to a loan. The value of all loans was capped, so it became illegal to add interest exceeding the original value of the loan (ie, double the value); an initial cost cap of 0.8% per day was introduced, as was a £15 cap on default fees (for late repayments).

Affordability Checks

In the summer of 2017, the FCA followed up on its 2014 legislation with a consultation (consultation paper 17/27) which called for the introduction of affordability checks within the HCSTC market, before publishing the final policy paper in July 2018.

Within the policy papers, the FCA clarified a number of major factors. These were:

- The distinction between affordability and credit risk
- The criteria for deciding proportions of assessments
- The role of income and expenditure information
- Their expectations of firms' policies and procedures

In July 2018, new policy papers (18/19) were published, with implementation going live in November 2018.

The outcome of the paper was for "firms to make a reasonable assessment, not just of whether the customer will repay, but also of their ability to repay affordably and without this significantly affecting their wider financial situation. This should minimise the risk of financial distress to customers."

The FCA had to strike a balance between consumer protection and a recognition that the economy is still largely fuelled by debt. The FCA had to ensure that there are consumer protections, combined with knowledge that if it is too restrictive, the cost of credit will rise for everyone.

Required Assessments

The FCA has stated that it wants firms to make a reasonable assessment, not just of whether the customer will repay, but also of their ability to repay affordably and without this significantly affecting their wider financial situation. The FCA has demanded all firms establish creditworthiness and affordability checks, and have policies and procedures to ensure robustness. Policies must take into consideration the principal factors for consideration and be signed-off by senior management.

The role of income becomes very important because of one change that the FCA has made, which is that unless they have intimated otherwise, the assumption is that all applicants will repay credit direct from income made through salary. It can however, include income from savings, or income from another person (such as where household finances are pooled).

The FCA has deliberately not been prescriptive in its recommendations to establish affordability and creditworthiness within firms. As we have seen with other areas of financial services regulation, such as on rules concerned with Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF), they are focused solely on outcomes. This, then, gives firms leeway in how they approach the new recommendations.

The Undoing of Wonga

The strand of financial services that has come in for most criticism in recent years for their credit practices has been the pay-day loan or High Cost, Short Term Credit (HCSTC) sector.

The Wonga Saga

In the summer of 2018, pay-day loan company Wonga fell into administration. Despite receiving a cash injection of around £10m from investors, the company succumbed after changes to the law and customer complaints regarding historical loans began to bite.

The collapse of Wonga has stemmed directly from the volume of complaints it received and resulting compensations payouts due to its lending practices.

The negative persona attributed to Wonga is understandable. Prior to the FCA rule changes in 2014, short term loans based on an APR of 5,853% were available. Customers could further “roll over” loans, increasing interest further. While Wonga always claimed it sought to give loans to professionals and those that might need them “two or three times a year”, many customers were those least likely to be able to afford repayments.

The 2014 regulations had the dual impact of seriously curtailing Wonga’s profit margins. Loans with an APR of many thousand percent were stopped, adversely impacting profit margins. The possibility that customers could seek redress for being sold unaffordable loans also alerted claims management companies. Claims against Wonga for selling patently unaffordable loans have been the principal cause of its demise.

In 2014 alone, the firm wrote off £220m worth of debt belonging to 330,000 customers for selling loans that were unaffordable. Since then, claims to the Financial Services Ombudsman (FOS) have continued to spiral upwards. The FOS reported a 215% rise in the volume of claims made against pay-day lenders in the first six months of 2018 compared to the last six months of 2017. Of these, Wonga was responsible for 4,513. The 2014 FCA regulations had a serious impact for loan providers. As we noted on page 1, the industry has significantly less actors in the market then it did five years ago as a result of these regulations.

These claims were detrimental because as well as having to pay back interest and charges where the FOS has found against them, they were also charged an administration fee of £550 for each one. It is this bill and recurring redress payments to customers that has precipitated their decline.

Lenders must therefore ensure that they are in a position to address the new regulations implemented in 2018. How can they ensure that customers are creditworthy and have sufficient disposable income to be able to repay loans without being placed into financial distress?

The Answer: Open Banking

What Is Open Banking?

Open Banking is a secure way for customers to use financial products and services from regulated apps and services. As a financial services term and part of financial technology, it refers to the use of Open APIs (often also referred to as public API which enables third-party developers to build applications and services utilising bank data.

The aim of Open Banking is to encourage innovation and improve competition, by making it easier to hold multiple accounts and compare or switch financial products.

Ultimately, it could allow the management of all financial accounts and household bills through a single digital platform, with the option of allowing apps to ‘plug in’ and offer more personalised and intuitive services. For example, an app might help to avoid charges or boost savings by automatically moving money between various accounts. Open Banking could also spur action in other markets, by encouraging consumers to look at their energy or phone bills. It will increase the speed in which we apply for financial services online.

How Could Open Banking Be Used?

In the context of affordability, Open Banking can answer all the questions that will be asked of a customer. Open Banking can provide a bank or financial institution with a consumer’s salary or income, thereby negating the need for them to send in bank statements. With the ability to see what outgoings the applicant has compared to salary or income, calculating discretionary spend becomes far simpler. With sight of discretionary spend and available resource, financial institutions are therefore much better placed to make judgements on whether a loan is affordable for the applicant.

Open Banking is even wider than affordability. As technology has progressed, data and the use of data has become ever more important. As illustrated by the Facebook-Cambridge Analytica scandal, and the introduction of GDPR in the EU, strict limits are being imposed on how customers data is utilised. The introduction of Open Banking facilitates individuals taking control of their own financial data. This in turn will allow for personalisation of services and consumer choice for the individual.

The Solution: DirectID

DirectID has been working with bank data since 2011. DirectID, our B2B offering, was launched in 2015 to offer financial institutions' customers a seamless onboarding experience.

Today, DirectID integrates with over 11,000 banks across 40+ countries (including the CMA9 and Monzo and Starling Bank in the UK), with 30+ customers globally.

What Does DirectID Do?

DirectID offers lenders and financial institutions the ability to make affordability assessments and calculate disposable income quickly and efficiently. DirectID provides comprehensive reporting allowing for quicker and smarter decision making.

Applicants share their bank transaction data, direct from their account, through a simple online process that takes just 25 seconds. Up to 365 days of transaction history is provided through an API or reporting dashboard to support instant decisions or speed up manual underwriting processes.

How can DirectID be used?

DirectID powers credit risk underwriting for online lenders around the world. We help our customers:

- Grow their customer base
- Meet responsible lending requirements
- Reduce loss rates and conduct sound risk mitigation
- Reduce fraud and misrepresentation
- Increase operational efficiency

The value of verified data is realised through the decisions it drives and ultimately how it helps businesses achieve growth. DirectID reports on customer's bank account and transaction data, and in real-time to help vendors make the fastest and most accurate decisions, as well as optimisation of process. Data is reported through an online Dashboard or integrated through the Data API.

Conclusion

The onus on lenders has increased considerably since the FCA began to examine the subject of affordability and creditworthiness.

The impact of the 2015 regulations should not be understated. The volume of HCSTC lenders has dropped significantly in the intervening years since the regulations were made live, and as we've highlighted, led directly to the collapse of the largest player in the market, Wonga.

Current regulations make it mandatory for lenders to calculate affordability, either as part of, or in conjunction with credit risk. The FCA has been deliberately vague in how this should be calculated, placing the focus on outcomes rather than process. Lenders therefore need to be able to demonstrate how decisions were arrived at.

It is at this juncture that DirectID, through the power of Open Banking, comes into its own. Decisions that could take days prior to the arrival of Open Banking can now be done in minutes. Discretionary spend and affordability can be reliably assessed without the need for customers to send in paper statements.

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