

CAN YOUR CUSTOMERS AFFORD THEIR CREDIT?

Credit scoring models can only take you so far when deciding who is a good candidate for credit. The main question you need to ask is can they afford to pay it back?

By Rebecca Lucas

Why is it, when most lenders have in place sophisticated credit scoring models to assess an application for credit, that something as fundamental as whether the applicant can actually afford the credit is often overlooked?

The answer is twofold. Firstly, there is the basic lending premise that an applicant, in applying for credit, has both

considered and concluded that they are able to repay the debt.

In fact, in recent times, the benign economic climate and period of low interest rates has served to create an environment where this premise is rarely questioned.

Secondly, it is deemed very intrusive, particularly with point of sale finance, to ask an applicant detailed questions regarding income and expenditure. This therefore makes calculating 'affordability' considerably more challenging.

The industry has recognised this and has made best use of whatever data is available, with the development of various indices that provide an indication of the applicant's level of indebtedness. While this clearly helps, unfortunately it provides only half the answer, as it is only in the context of an applicant's

income that the level of indebtedness



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becomes meaningful and as such allows some applicants to be categorised as over-indebted.

Addressing this issue will cause problems for many lenders, but the pressure from government to pay more attention to the assessment of affordability is only likely to get stronger, particularly with the highly publicised levels of unsustainable consumer debt and personal bankruptcies reaching their highest level since 1992.

It therefore seems that addressing the issue of affordability is not in question, but the problem is how to calculate it, particularly when it is likely that full details of an applicant's income and expenditure will not always be available.

Clearly, where data is available it should be used, but any affordability metric needs to bolster this with inputs from a variety of widely-available public data sources and have the ability to substitute, estimate, calculate, extrapolate or use any other modelling technique as appropriate to derive the assessment.

The modelling process

This article discusses how the various inputs required may be accurately modelled and how a cost effective and operationally efficient affordability metric can be calculated and used.

The inputs can be broadly classified into four key components and the issues surrounding the accurate assessment of each are as follows:

◆ Income.

Firstly it has to be clear that the availability of the applicant's income is fundamental to the assessment of affordability.

It should also be recognised that there is no reliable method to estimate income. Attempts to do so tend to be based upon demographic data, postcode statistics and the very levels of debt to which the resultant income will ultimately be compared.

The net result is that high levels of debt generally result in high income estimates, and low levels of debt in low income estimates. Whilst the model could include some adjustment factor to break this relationship, one would need to question the reliability of such a model.

Therefore, having accepted that income needs to be captured in some way, consideration needs to be given to what elements will be included. Thought needs to be given as to whether income is captured as gross or net and, irrespective, the model should hold tax rates so that either can be calculated from the other.

Joint and single applicants need to be catered for and a decision taken on whether to use basic income only or to allow for the inclusion of any overtime or bonus payments, and if so, on what basis.

◆ Credit commitments.

In terms of indebtedness, credit commitments are perhaps the most obvious type of expenditure and data are obtainable in varying levels of detail from the credit reference agencies (CRAs). This will give a picture of an applicant's likely monthly payments on secured and unsecured credit.

Care must be taken when assessing monthly payments, as in isolation they can present a false picture and so require the additional assessment of the type and size of debt and whether those monthly repayments are merely minimum payments or is the debt burden actually reducing. Minimum payments flatter the affordability position in the short term but consideration has to be given to the fact that the capital will need to be repaid at some point.

It also has to be remembered that varying subscription levels amongst lenders and differences in CRA processes will mean that the CRA will not contain a complete picture of the applicant's credit commitments. It is therefore vital that any affordability metric includes some form of modelling in this area.

◆ Housing expenditure.

Housing costs are likely to represent a significant proportion of an applicant's outgoings and thus an affordability measure will be very sensitive to the assumptions underlying any estimates of rental and mortgage payments.

Where the applicant is a tenant, various public data are available on average rental amounts at both geographic and demographic levels. From this set of data it is possible to

develop models to produce a more refined estimate based upon all available information.

The inclusion of mortgage payments in an affordability measure is somewhat more complex. Despite the fact that secured credit commitment information is held by the CRAs, it is common to find that a mortgage record is returned for only 50–60% of applicants who state that they are owners. The remaining 40–50% of 'owners' will need the housing expenditure to be estimated. Any approach will need to cater for:

- ◆ Soft fraud cases – the 'owners' that are not actually owners.
- ◆ Owners who own their homes outright and therefore have no monthly mortgage commitment.
- ◆ Owners whose mortgage is with a lender that does not contribute data to the CRAs.

The impact of failing to differentiate between these three cases would mean that any model would over-penalise the lower-risk mortgage-free owners and would over-promote the potentially higher-risk renters.

When one considers that housing costs are likely to be the single largest component of an affordability measure, the quality of the estimations underlying the model and the calibration of these to lenders' differing applicant profiles become paramount.

◆ Lifestyle expenditure

The inclusion of lifestyle expenditure presents its own set of problems. This information is more difficult to come by and more complex to apportion by customer profile, and while there are a number of known universal factors, it is very much down to each individual lender as to how such items are treated within the model.

There needs to be a clear appreciation of the likelihood of being able to accurately and reliably estimate lifestyle expenditure using the data available at point of sale.

Generally, any lifestyle expenditure needs to be separated into 'essential' and 'non-essential' items, as these clearly have a very large impact on a household's ability to curb their budgets in times of financial stress.

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>> **The affordability metric**

The combination of these four components allows the generation of a metric that can explain the ability of the applicant both to service the debt today and, considering changing circumstances such as increases in interest rates or taxation levels, to reduce the debt burden in the future.

The question is, then, how such a metric might be utilised in a decision process. Clearly, the primary purpose will be to identify those applicants that are heavily over-indebted and ensure that no further credit is granted.

Beyond this, the metric can be used in conjunction with other estimates, such as a probability of default provided by a traditional risk scorecard, to flex the score cut-off, to determine credit facilities that will be offered in terms of absolute limits or within price-to-risk strategies, to identify any up-sell opportunities or to add a further dimension to a multitude of other lending strategies.

Finally, it can be used to determine which potential accepted cases need to

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be referred for further income verification or for a full income and expenditure assessment prior to the acceptance being confirmed.

Summary

It is fair to say that, for most forms of credit, the assessment of affordability is now considered fundamental in the approach to responsible lending. With changing economic forecasts and increased levels of consumer debt its importance can only grow.

For some organisations the route may be to undertake a full income and expenditure exercise with the resultant impact on data capture requirements. Where this is not applicable then an affordability metric can provide an estimate of an applicant's debt burden to income position.

This metric, like any other statistical model, needs to be tailored to the

relevant portfolio and monitored on an ongoing basis to ensure continued performance. There is no 'one size fits all' model but a generic framework can be applied with exact parameters 'flexed' to each lender's circumstances.

Finally, the implementation of the affordability metric could merely be seen as just another tick in the box for meeting regulatory pressure; however, there are also clear business benefits to be gained. The metric will help reduce bad debt but will also support a more streamlined application process and, where circumstances suggest, can be used to offer higher advances to those that can genuinely support that level of debt. **CCR**

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