

RESPONSIBLE LENDING - WHAT'S THE SCORE?

What role does credit scoring technology play in 'responsible lending'? Has it fallen short - given the high rises in impairment charges and customer indebtedness? Who decides what 'irresponsible lending' is - what actions should apply if it occurs - and what defence can a lender mount if accused of it?

UK Lenders pride themselves on the introduction of highly efficient automated systems to help provide credit more effectively and at much lower cost. In 2004 some signs of over-indebtedness started to appear though earlier years 2001 to 2003 appeared to be stable and sound for both lender and borrower. This over-indebtedness phenomenon does not appear to apply to prime mortgage lending even now but is prevalent in segments of sub prime lending and in general and unsecured borrowing in particular.

The impairment charges for unsecured loans, at a national level, were analysed and were seen to have rocketed in the past four years. Reaching multi-billion figures in each year - with 2005/06 looking particularly bad. In addition - consumerists, government and regulators have been critical of the nature and amount of lending extended. The culmination of this concern was to widen the powers of the OFT to investigate responsible lending within the ambit of the new Consumer Credit Act - and by implication to empower regulators to review lending practices. Some money advisors have already formally challenged lenders on the validity of lending decisions to their clients who are in serious default. Some have written-off loans as a result!

Overall - this suggests that there may be something wrong with either a) the scorecards used or the decision making logic, or b) the processes being used to make the decision, or c) that management has taken - overtly or accidentally - decisions that have ultimately proven to be too risky. A counter argument may be that a) and b) are in good order but the volume of business and pricing thereof was judged to be sufficient to handle the anticipated impairment charges and still provide an acceptable profit. It is known though that the substantial impairment increases in certain markets have been so unexpectedly high as to have created losses or significant profit downturns for some lenders.

This Paper considers poses and partially answers a number of fundamental questions on the role, attitude and performance of the borrower - the nature of the impairment problem - Credit References - affordability measures - the construction and use of scorecards - management controls - profit maximisation - and external factors that may be outside the control of lenders.- but this is by no means a complete list:

- Why are impairment charges so high?
- What factors have led to the increases in impairment?
- Is there a new perception by borrowers that 'you don't have to repay'?
- Are borrowers leveraging their 'good' credit record - while they can?
- Have past products and previously incomplete CRA information made affordability assessment difficult and complex?
- How good are lending management controls and forecasting and trend analysis?
- Has income maximisation (in the short term) been in conflict with prudent lending and longer term profit?
- How robust and defensible are scorecards, the assumptions within profitability models and lending policy and practices?
- Are current methods of scorecard testing and review adequate?
- Are score cut-offs in the right place and how sensitive are they to even small changes in customer performance?
- Would the difficult/complex processes undertaken be understood and stand up in court?
- On what basis will/can 'responsible lending' be defined? Will the FSA and the OFT be setting guidelines?
- How is 'affordability' to be measured - given that some 'lie', rapid changes to personal circumstances', frequent re-mortgaging and the frequency of balance transfers?

This also creates a substantial ethical challenge for practitioners. There have been cases where the ability of senior credit risk managers have been considered to be the problem and some have been sacked. Others - have left as they were unwilling to condone the taking of extra risk in order to achieve lending volume targets. In either case, the questions posed above bear consideration as there may be technical as well as managerial reasons for the current problems being experienced.

These observations are based on practical recent experience and only scratches the surface. More precise research is under way. will be needed on such a fundamental issue. It is a critical time to raise the above and other questions as regulators - including the Financial

Ombudsman - and judges in courts will require evidence as to the fairness and validity of lending decisions will be needed in the future.. Dialogue with key stakeholders will be needed.

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