

Credit Scoring & Credit Control Conference X

Responsible Lending

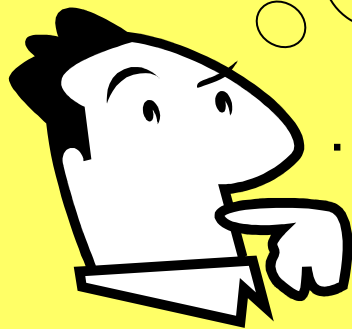
George Wilkinson
29th August 2007

First,
let me tell you
a (true) story...



It was 40 years ago today...

George thinks...



... family ... holiday ... new car ... bank loan?

.... 40 years ago today...

George asks the Bank
– but it says “no”...

Why not?

I’m OK...

But I’m good
for the amount



... 40 years ago today...

But the dealer says "yes" to a loan!...



...Just needed to cross the road...!



Some questions...

- Why was George declined – would today's scoring make any difference?
 - **Was a responsible lending decision made by the bank?**
- Why was the finance company (dealer) able to accept?
 - **Was a responsible lending decision made by the finance company?**
- How did George know he was OK for the loan?
 - **Was a responsible 'borrowing' decision made by him?**
- Was the finance company loan more expensive? Yes.
 - **Was a higher charge fair – and – was it responsible lending?**
- Did he make the payments? Yes – and his history was on record – the Bank's would not have been.
 - **Was data sharing part of responsible lending?**

“Today” ... not much has changed

“FLA members financed at least 50% of all new car registrations in the UK in 2006. “ (Finance & Leasing Association)

“Some 37 per cent of unsecured borrowing last year was made by non-banks who are not subject to the “responsible lending**” provisions of the Banking Code.” (British Bankers Association)**

“Banking has changed hugely in recent decades and as a result there are 150 million bank accounts in the UK.” (British Bankers Association)

“We will not entertain any loan without payment by direct debit.” (Finance Company Director)

**Bank customers still choose to use finance companies!
Are banks responsible - and other lenders not?**

Despite high bank penetration – risk segments are serviced differently

Main Suppliers	Credit Risk (Broad)	APRs Charged	Bank Penetration
Banks	Low Medium	Low Medium	Very High High
Finance Companies	Medium High	Low Medium High	High Medium
Higher Risk/ Sub Prime	High Very High	High	Low

- Even within the above – further ‘ risk based pricing ‘ applies to achieve the right income/risk ratios in specific business models...
- ... facilitates wider provision to different customer risk segments – but what if ‘ responsible lending criteria ‘ is too closely defined

“Responsible Lending” UK Codes & Impairment – US Trends & Stakeholder Positions

What does the UK Banking Code say?
How is it perceived?

What has been the UK trend in unsecured bad debts – recently?
Are lending practices questionable?

What’s happened in the US in past years and months?

What do consumerists have to say about responsible lending?

Where do the FSA and OFT stand?

Lenders – regulators – and consumerists – seem to have their own views on ‘responsible lending’ and its definition!

UK Banking Code

- **Section 2** says:
 - Banks will **act responsibly**
 - properly manage/provide **literature**
 - **explain** products and charges
 - send regular **statements**
 - deal with **problems** quickly/simplely
 - keep information **confidential**
- **Sections 10 (Cards) and 13 (Lending)** are more specific (see later)
- Ironically – the separate OFT approved '**Guide to Credit Scoring**' is supported by banks and says:
 - “As responsible lenders, banks take into account your personal circumstances to try to establish the appropriate level of credit to grant to you. To help them do this, applications may be assessed using a process called credit scoring”.

UK Banking Code – Sections 10 & 13

- **Section 10 - Cards:**

- Banks will - before credit limit increases – undertake appropriate **checks** and **assess** whether they feel you can **repay** but may choose to increase or reduce limits. Opt outs are possible from the former
- Limit requests considered after appropriate **checks**. They will ensure that minimum payments covers 1 months' interest, warn of promotional rates expiries and respond if you don't want automatic cheques provided

- **Section 13 – Overdrafts & Borrowing:**

- Will assess whether they **feel you can repay**
- Overdrafts requests **considered** – if they cannot help they will explain the main reason
- Explain **credit reference agencies**, submission of data to them on missed payments, disputes, lack of proposals - and on day to day running of the account (with permission)

Above indicates a 'broad brush' approach towards 'lending decisions' and makes no reference to **credit scoring** - directly

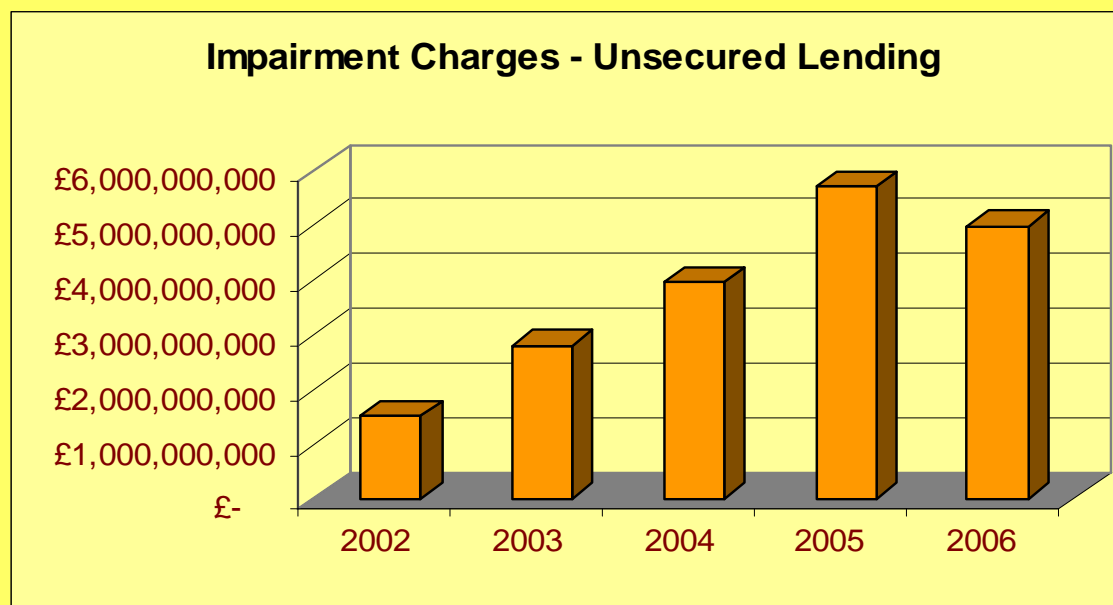
How is the Banking Code perceived by FSCP*?

- **FSCP** concludes that it:
 - requires changes to better **fit** the rest of the regulatory environment
 - sets a **lower standard** of ‘fairness’ than the **FSA** and the Financial Ombudsman Service (**FOS**)
 - is **fair** only within its own context and should **adopt** the more all-encompassing concept of fair treatment the FSA uses
- **FSCP** believes the **FSA** needs to:
 - consider playing a larger role in the **regulation** of retail banking
 - ensure that its **rules** are **not** replaced with **industry codes** which lack public consultation/the consumer interest
 - **approve** the Banking Code and make the final decision upon changes to it

The Banking Code is judged **deficient**, here – BUT may not be sufficiently explicit on responsible lending

***Financial Services Consumer Panel (FSCP)** represents consumers – is independent of the FSA but comments on its policy/practices

Impairment Charges – 2003 to 2005 GWA Sample/Initial Analysis* – UK Unsecured Lending



- Credit cards and personal loans – dominated by major banks (circa 90%)
- Balances flat (£257bn) – 2004 to 2005 – implying impairment uplift of 45%
- Three year summary positions - £8.2bn, £12.5bn, £14.7bn
- 2002 and 2006 estimated – latter improving due to tighter criteria

***GWA client project (August 2006) – benchmark exercise – updated July 2007**

Fundamental questions on 'lending practice'

Were **scorecards** robust/optimal/up-to-date/properly **monitored**?
Were they over dependent on incomplete credit reference data?

Were the **amounts** lent – or **limits** set – materially different from typical borrower exposures of former years?

Were **cut-offs** or **policy** rules stringent enough? Or were lending decisions made to optimise business volumes. Were **affordability** assumptions, estimates or calculations incomplete or flawed? Were **profitability** assumptions realistic?

Was sufficient attention given to - general **economics** – **customer** behaviour – **repayment** attitudes – **over borrowing** trends and market practice

'GWA survey of credit risk managers – early limited sampling' suggests serious flaws in most the of above areas. Some enforced staff departures & voluntary ones evident. Survey continues, funds permitting!

What's happened in the US in past years and months?

* Predatory Lending on mortgages admitted by Citibank & Wells Fargo

* Growth in house supply – low rates – sub-prime push – risky customers

* One in five are sub prime mortgages – several million foreclosure risks

* Lender dependence on FICO scores – Moodys say they are not working

* Consumer Mortgage Bonds/refinancing market in chaos – banker's pain

Domino effect – housing sales down – payments up – income static – etc
'AFFORDABILITY' SELF CERTIFICATION – UNDERWRITING issues !!

Consumerists and responsible lending?

* 'US Centre for responsible lending' – academics/policy – pro consumers

* CRS against wide 'lender abuse' - overdrafts/motor/loans/sub-prime/cards

* UK's NCC – campaigns on bank charges/card interest formula/HC/RC. *

* Large Brussels conference devoted to the topic – international focus

* CAB – an enforcer too – persuades major bank to write off 'bad lending'

* FOB service (£57m pa) – wants loans written off for lending in 'bad faith'

Consumerists and Regulators somewhat interlinked
Especially as Enforcers under the Enterprise Act

Wide range of attacks on pricing – interest rates – marketing – Payment Protection – Home Credit – Retail Credit etc,

Where do the FSA, OFT stand?

FSA new focus on sub-prime – recent reviews - fines/censures.
Indications that **lending approach/affordability** measures are **poor** for such a 'known' high risk market (Target market those with a CCJ)

FSA wanting current affordability and **future likely payment capability** to be assessed – citing retirement within term as a specific risk - despite **evidence** that mortgages are short lived and such payments are sound.

On **PPI** – FSA saying it must be 'bought' rather than 'sold'

OFT/FSA separate regulators – some overlap – work together/ with others

OFT draft rules for responsible lending look quite subjective/risk averse

OFT flagging that 20% of complaints have legitimate beefs against lender

Lenders are having to defend higher risk markets – Home Credit – Retail Credit – Motor finance – Sub prime mortgages and loans –and the underpinning provided by Payment Protection

Conclusion

- OFT/FS draft responsible lending **guidelines** misguided – despite some involvement from the industry. Interpretation could be wide-ranging/prescriptive/self serving - industry is not confident of the outcome. Some decision making under scrutiny.
- ‘Practitioners’ typically assume it is just about making credit decisions - but it’s wide-ranging. They need to examine current practices, consider professional representation for themselves - achieve greater involvement in OFT/FSA responsible lending.
- Consumerists anticipate a wider definition and typically expect
 - **perfection** on declines and accepts and fulsome explanations at the outset/afterwards
 - low interest rates and caps, minimal fees, scale back on risk based pricing, clarity at all times and “fairness”

IS THIS THE DEATH KNOLL OF NON STANDARD FINANCE?

Conclusion

- Government is
 - expanding regulation
 - likes “one size fits all” solutions
 - is optimistic regarding delivery from regulators
 - lacks understanding of market complexity, issues and UNINTENDED consequences
 - runs risk of under supply of riskier credit and bank dominance
- Many lenders think they are “responsible lenders” including those in high risk markets with high APRs.
- Existing business models may not be sustainable if responsible lending criteria is set too high

THIS – AND THE CURRENT FUNDING CREDIT SQUEEZE CAN HAVE A DRAMATIC EFFECT ON UK CONSUMER CREDIT !!