#Buildbackbetter for personal financial wellbeing - insights into policy development priorities for a post Covid-19 environment

Briefing Paper BP12/2020

Credit, Risk, and the Pandemic

Damon Gibbons
Executive Director
Centre for Responsible Credit Ltd

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Credit extension to households has long been understood as a helpful mechanism through which people can smooth fluctuations in income and expenditure and raise capital for productive investment[1]. However, the extent to which an individual can access this important tool, and the terms on which they do so, is restricted by lender risk assessment processes and charging policies[2]. In turn, these processes and policies are framed by legal and regulatory requirements[3].

In the context of a pandemic which has delivered a severe income shock for millions of households, but where the economic impacts are unevenly distributed, questions arise as to how risks should be assessed moving forwards. Should we maintain the system of social discrimination of the past, which now seems likely to constrain credit extension on affordable terms to those groups which need it most, or refresh our approach to incorporate considerations of social justice and fairness?

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[1] Deaton, A. S. (2005) 'Franco Modigliani and the Life Cycle Theory of Consumption'. Available at SSRN: https://ssrn.com/abstract=686475 or http://dx.doi.org/10.2139/ssrn.686475;

[2] Marron. D. (2007) 'Lending by numbers: credit scoring and the constitution of risk within American consumer credit', Economy and Society, 36:1, 103-133.

[3] In the UK, these are particularly set out in the FCA's rules relating to 'creditworthiness assessment' which include requiring lenders to consider whether the borrower can afford to repay.

Risk assessment before Covid-19

Credit risk assessment involves the segmentation of the population into separate risk classes: identifying, with the use of varied data sources and statistical techniques, those combinations of borrower characteristics most closely correlated with past default events and using this analysis to estimate the likely propensity of default for different segments of the population moving forwards[4].

Chief amongst the data sources used are the actual payment histories of individual borrowers, which in the UK are stored on credit reference agency databases for a period of six years. This is generally supplemented with public information and that gleaned through credit application processes. For example, current income and living costs, age, and household composition, length of time at current address etc. as well as with proprietary data held by lenders on people who have borrowed, or taken other financial products, from them previously.

Levels of access to credit (i.e. whether or not an individual application will be approved, and, if so, the amount of credit to be offered) as well as the cost of that credit, are therefore determined by a process of both *individualised* and *social* discrimination[5]. We may like to think that our individual records are primary, but our generalised position in society also comes into play. This is particularly so, but not exclusively, where an individual history of payment data is lacking[6]. My credit score is what it is not just because of my own repayment history, but because of the repayment histories of people who look like me.

Regulators have facilitated developments in data sharing in recent years, and the advent of Open Banking in 2018 has been particularly important[7]. Since when historical default information has been in the process of if not being entirely supplanted by, at least supplemented with, real time information concerning revenue and expenditure flows and financial (by which we mean spending) behaviours. The mining of current accounts, previously the preserve of banks and building societies and undertaken on a proprietary basis,

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[4] The field is constantly evolving. For a relatively recent review of the different predictive models in use see Lessmann, S., Baesens, B., Seow, H. V, & Thomas, L. C. (2015). 'Benchmarking state-of-the-art classification algorithms for credit scoring: an update of research'. Available at https://crc.business-school.ed.ac.uk/wp-content/uploads/sites/55/2017/02/Benchmarking-State-of-the-Art-Classification-Algorithms-for-Credit-Scoring-Lessmann-Seow-Baesens-and-Thomas.pdf

[5] Neuberger, D. & Reifner, U. (2019). 'Systemic Usury and the European Consumer Credit Directive'. Thünen-Series of Applied Economic Theory - Working Paper, No. 161, Universität Rostock, Institut für Volkswirtschaftslehre, Rostock. Available at: https://www.econstor.eu/bitstream/10419/209120/1/wp161thuenen-rev.pdf

[6] For a critique of approaches to 'score the unbanked' see Aitken, R. (2017). 'All data is credit data': Constituting the Unbanked'. Competition and Change. Vol 21(4) 274-300. Available at: https://www.researchgate.net/profile/Rob_Aitken3/publication/317727851_'All_data_is_credit_data'_Constituting_the_unbanked/links/5cd47662458515712e9ee577/All-data-is-credit-data-Constituting-the-unbanked.pdf

[7] This opened up current account information, previously the proprietary reserve of banks and building societies, to third parties, with the stated intent of promoting innovation and competition in the financial sector.

is now open (with an individual's consent) to all. Other approaches have also been explored, including social media presence and network analysis[8].

The dangers to this data driven approach should be clear: there is virtually no aspect of an individual's life which lenders cannot claim is relevant to risk assessment. The pandemic may, for example, result in a drive for access to health data: whether a borrower falls within a social grouping that is vulnerable to the virus could have a bearing on their ability to repay.

And because borrowers are constantly reminded of the importance of maintaining their credit scores, it is entirely possible that the disciplinary effects[9] of data sharing result in behaviour change. Credit risk assessment systems have the potential to act as a form of soft control[10].

The outbreak, credit extension and credit reporting

The outbreak of Covid-19 provides a considerable challenge to the way we think about credit and risk. In response to income shocks, further credit extension could (in theory) be used to help households' weather the storm, but at the same time (in practice), lending has become a whole lot riskier. How can we square the circle?

The initial response of policy makers was to intervene to support both lenders and households. The Bank of England introduced a new Term Lending Facility to provide banks and building societies with cheap capital, intended to allow them to keep lending[11]. Government took on responsibility for the payment (at least in part) of wages. Lenders are being provided with help for a period of four years. Household support is being reduced after just eight months.[12]

Despite these measures, it was quickly apparent that the lockdown would impact the ability of millions to repay in accordance with their contractual obligations. Two basic options presented themselves to policymakers: do nothing or do something.

The do-nothing option would have led to enforcement action to pursue arrears and the impairment of millions of credit files; if and when the pandemic passed, those with impairments, as well as people who looked very much like them, would be declined further

[8] See, for example, https://knowledge.wharton.upenn.edu/article/using-social-media-for-credit-scoring/
[9] Japelli, T. & Pagano, M. (2005). 'The role and effects of credit information sharing'. Working Paper No. 136. Centre for Studies in Economics and Finance. University of Salerno. Available at: http://www.csef.it/WP/wp136.pdf
[10] The techniques of credit risk assessment are currently being applied in China to create 'social scores' as a means of behavioural control. https://time.com/collection/davos-2019/5502592/china-social-credit-score/
[11] https://www.bankofengland.co.uk/markets/market-notices/2020/term-funding-scheme-market-notice-mar-2020
[12] Notwithstanding the recent announcements regarding the Job Retention Bonus, new Job Support Scheme and the extension of the Self Employment Income Support Scheme.

access to credit, or at the very least, charged a premia for future borrowing. That would likely hold back economic recovery.

In the alternative, a do-something option was formulated. This involved payment deferrals, and the temporary suspension of credit reporting in the hope that a V shaped recovery would soon allow for a resumption of lending to borrowers who remained, fundamentally, a good financial risk. No consideration appears to have been given to those groups whose recoveries would take a very different shape.

We will likely never know whether it was the prospect of lenders going out of business in the face of mass defaults on both mortgage and consumer credit agreements, or social justice considerations (the defaults would be no fault of the borrowers) which swayed the argument. However, by 9th April, the UK appeared to have plumped for doing something, with the FCA's press release that day announcing temporary measures to provide households with access to 'payment deferrals'[13]:

> *"Payment deferrals are intended for those who might otherwise have been in good financial standing but have suffered a temporary income shock as a result of coronavirus."*

In addition, the release declared that lenders would be expected to "ensure consumers using any of these temporary payment freeze measures will not have their credit file affected."

These interventions were welcome[14]. They provided the basis of continued communications between lenders and borrowers, and we hoped (and still do) that they would also lead to greater use of forbearance arrangements once the deferral periods ended and to a rescheduling of outstanding debts, rather than a strict enforcement of pre-pandemic contract terms.

The devil in the detail

However, whilst *seemingly* protecting the credit records of impacted borrowers, the FCA's policy statement of 9th April unfortunately contained further devil in the detail[15]. This referred to "complex issues surrounding how payment deferrals and other forbearance measures are reported to Credit Reference Agencies and how these may impact credit files", and noted that:

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[13] https://www.fca.org.uk/news/press-releases/fca-confirms-temporary-financial-relief-customers-impacted-coronavirus

[14] Although we also argued at the time for the Bank of England's Term Lending Facility to be extended to non-banks and for this funding to be used to support a freeze in interest for the period of the payment deferrals. https://responsible-credit.org.uk/cfrc-responds-to-fcas-covid-19-proposals-calls-for-interest-freeze/

[15] Para 2.22, FS 20/3, 'Temporary financial relief for consumers impacted by coronavirus: feedback on draft guidance and rules', FCA 9th April 2020

> *"While we do not expect firms to report any worsening arrears status on a consumer's credit file during an agreed payment deferral period, we recognise that there may be a wide range of factors which influence a credit score. Our intention is purely to provide temporary relief for consumers during the deferral period during which their credit file is protected from any new arrears being reported. We would expect any other forbearance, for example in the form of waived interest and charges, to be reported in the usual manner."*

It has subsequently become apparent that these "complex issues" allow lenders to continue to identify people accessing payment deferrals. Records of outstanding balances continue to be reported to credit reference agencies, which show increased indebtedness due to the continued accrual of interest on the accounts despite no arrears flag being present. In addition, lenders with access to Open Banking data can identify that a previously regular outbound payment to a credit provider has recently ceased.

These issues were picked up by the Financial Times, which reported on 27th July[16]:

> *"Borrowers were not warned for months that taking a payment holiday during the coronavirus pandemic could deny them future loans — potentially leaving millions to apply for temporary relief thinking their creditworthiness would be unaffected…. the FCA did not tell borrowers…that payment holidays or deferrals could still influence banks' willingness to lend to them — even if their credit scores or ratings were unchanged. The FCA has since clarified that "banks and lenders take into account a range of information beyond a credit score and will need to assess the affordability of loans".*

A look ahead

Whether or not the FCA's intervention was known to be a chimera from the outset, the fundamental issue as to whether we should seek to reform the UK's system of credit risk assessment in the wake of the pandemic remains.

Even had it been possible to effectively suspend the identification of borrowers accessing payment deferrals for a temporary period, this would only have ensured those exiting the pandemic with incomes sufficient to resume payments at a level acceptable to their lenders would be protected.

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[16] 'Delay in warning about payment holiday credit risk attracts criticism', Financial Times, 27th July 2020.

For those unable to do so (for example, those who have, or are yet to, lose their jobs) the current system will inevitably result in reduced access to credit, or increased premia. The development of an extensive, new 'sub-prime' market beckons: something which high cost lenders, despite their own current cash-flow problems, are apparently relishing[17].

This cannot be good for the UK's long-term economic prospects. As previously stated, credit is an essential tool for the management of cash-flow and a means for people to make productive investment. Constraining access, or, through risk-based pricing, reducing the utility of credit for those groups which have been disproportionately impacted by the pandemic[18] will undoubtedly hold back growth. It is also questionable on social justice grounds: the perceived credit risks of these groups having increased through no fault of their own.

In our view, an entirely new approach is needed. The pandemic, for a brief moment at least, forced the FCA to consider whether risk assessment systems should incorporate considerations of social justice and fairness. If borrowers are not culpable, why should they be punished? Is it better for contact to be retained with borrowers experiencing financial problems, and for debts to be rescheduled rather than push people into default?

These questions will remain after the pandemic has passed. Most credit defaults are the result of income shocks or changes in circumstances that are beyond the control of borrowers. Borrowers maintaining contact with lenders in times of difficulty are likely to be 'creditworthy' in the future despite their immediate payment problems. We need a system which responds to more than just the statistical risk of non-payment amongst different social groups in the short-term. It needs to recognise the wider and longer lasting risks to our economy and society of a lack of access to reasonably priced credit too.

Damon Gibbons
damon.gibbons@responsible-credit.org.uk
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The views expressed in this Briefing Paper are the views of the author and do not necessarily represent the views of CHASM as an organisation or other CHASM members.

[17] See 'UK subprime lender warns of going concern risks', Financial Times 25th June 2020. https://www.ft.com/content/189d3e59-8ebd-4889-9089-7ac19b9ea2fe
[18] See 'Covid-19 recession is having a disproportionate impact on the most vulnerable', https://www.lse.ac.uk/News/Latest-news-from-LSE/2020/h-August-20/COVID-19-recession-is-having-a-disproportionate-impact-on-the-most-vulnerable

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