THE NEW NORMAL

Why your existing credit models may no longer be enough

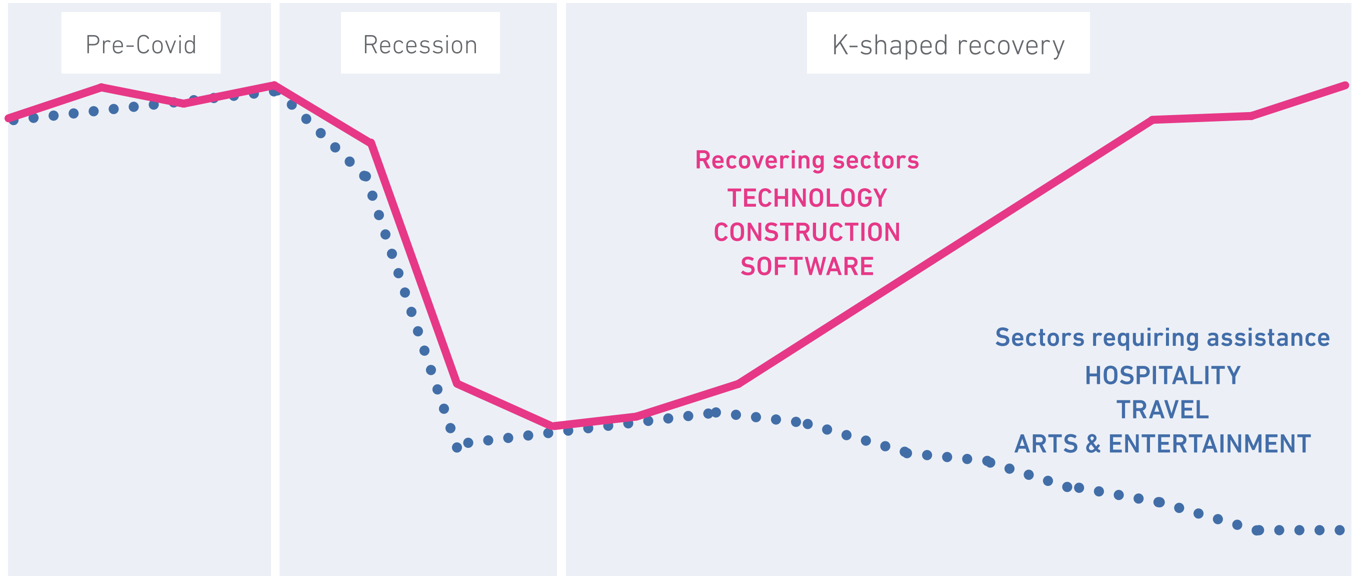
IS IT TIME TO REVIEW CREDIT MODELS?

The pandemic has created uncertainty around credit risk models. Payment holidays and government assistance may be masking customers' true financial circumstances. Understandably, lender confidence has dipped as a result. To address this, one third of businesses are planning to rebuild their models from scratch to improve performance.

BUSINESS CONFIDENCE IN CREDIT RISK MODELS HAS DROPPED WITH 1 IN 3 PLANNING TO REBUILD THEM FROM SCRATCH.

'Navigating a new era of credit risk decisioning' – Experian Global Decisioning Report 2021

THE K-SHAPED RECOVERY WILL CREATE A SPLIT WITH BETTER-OFFS AND THOSE DISADVANTAGED



With a K-shaped recovery, there is a split impact on businesses and consumers. There are groups who are coming out of the pandemic better-off and groups that have ended up disadvantaged to varying degrees. Some industries have been shielded or face a fast recovery, where others will require further assistance in order to bounce back to pre-pandemic levels. This has a knock-on affect on levels of turnover and profitability and as a result impacts the financial health of businesses and the consumers employed by those businesses.

AND THAT OUTLOOK TRANSLATES INTO TWO GROUPS WITHIN CONSUMER AND SME LENDING

Elena

‘UPWARD K’

Financially gained consumers and businesses

OCCUPATION

Software Developer

SITUATION

Worked from home over lockdown and has accrued savings with pent-up demand for new credit.

Josef

‘DOWNWARD K’

Consumers and businesses with greater vulnerability

OCCUPATION

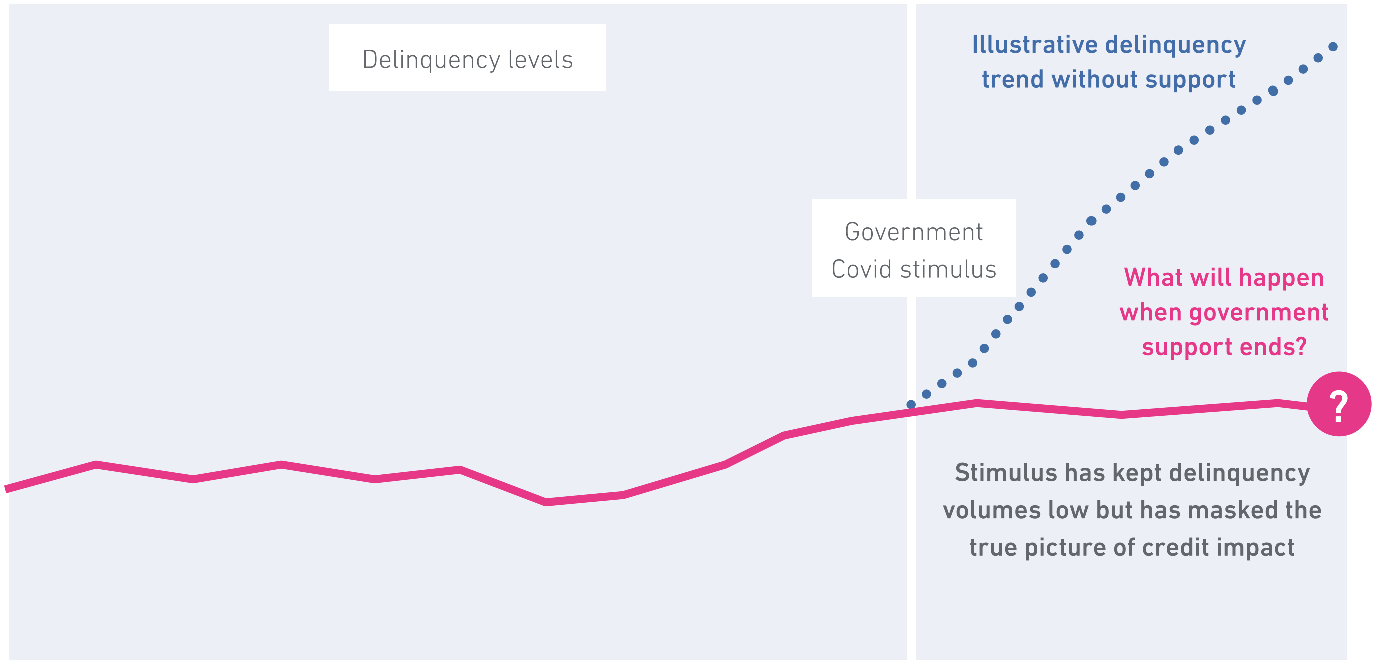
Sole Trader, Jo’s Coffee Shop

SITUATION

Open for takeaway for parts of lockdown. Sales significantly down. Relying on government support with 2 staff on furlough.

And this sector health impacts the small businesses and consumers who depend on it for employment. Essentially two groups are created – the fast recovery industries and the individuals whose work held up over lockdown have prospered and sit on that upward slope of the K with pent up demand for credit. At the same time others – the disadvantaged, many small and medium-sized companies, those consumers working in stricken sectors such as hospitality – they have had it tough, sliding down the downward slope of the K.

DELINQUENCIES HAVE NOT MET EXPECTED LEVELS WITH GOVERNMENT INTERVENTION CREATING THE GREAT DEFERRAL WITH DOWNWARD Ks CURRENTLY PROTECTED



Unemployment has not yet translated to credit delinquency. Government intervention has differed greatly, but the various stimulus packages provided by European governments have protected industries and jobs, in effect pushing out the crystallisation of credit risk. But at some point, that will end. The delinquency risk is still there but delayed. There are people that may have been hit hard but models are not showing the true picture. Affordability and cashflow assessment and ongoing monitoring is critical in the near term in order to detect early warning signs for vulnerability over the coming months.

WHAT DOES THIS MEAN FOR EXISTING CREDIT MODELS?

Traditional scorecards, developed using numerous variables, degrade over time. During the pandemic many of these variables have changed rapidly and drastically – including the economy, employment, income and consumer spending, savings and debt. Inevitably, the credit scorecards used pre-pandemic are no longer as predictive and accurate.

This is why many businesses have undertaken work to validate their existing credit scoring models to assess whether the models need recalibrating or rebuilding to better reflect the new normal.

35%

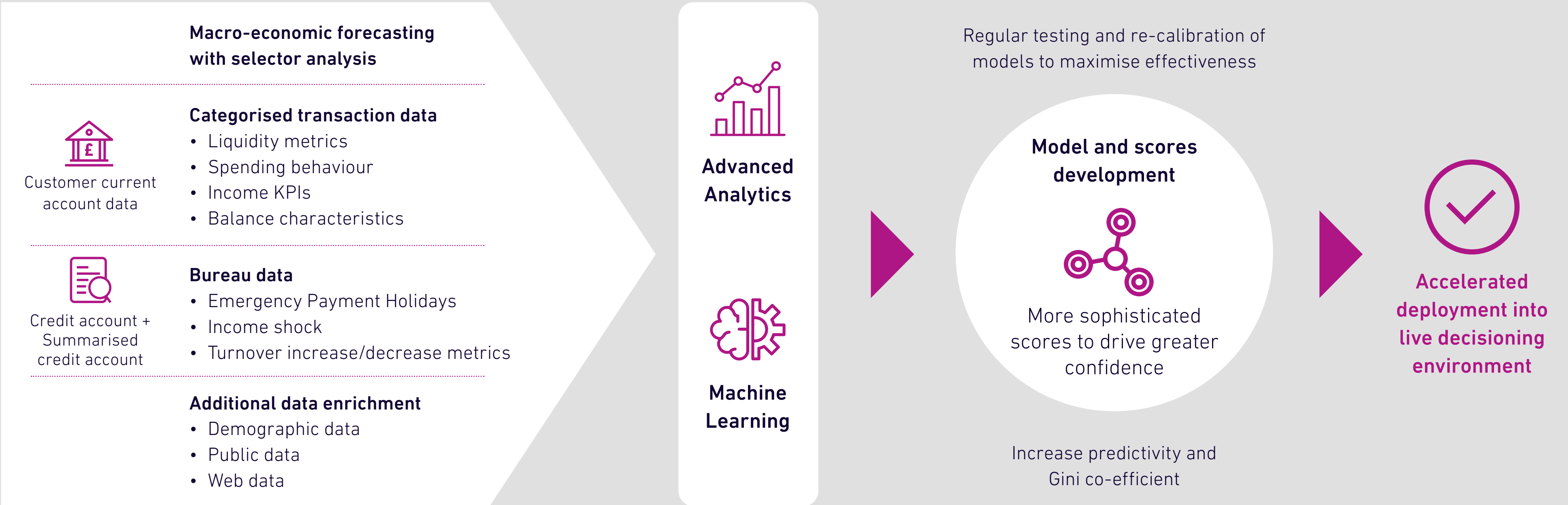
OF BANKS HAVE REPORTED A DOWNTURN IN MODEL PERFORMANCE AS A RESULT OF THE PANDEMIC

Impact of Covid on Data Science in UK Banking, BoE Survey Q4 2020

HOW TO RESPOND?

Additional data sources, such as transactional data from Open Banking (or in-house), should be integrated and blended to create more context led, sophisticated modelling, increasing confidence in decisioning strategy. Including macro-economic forecasting is also essential, especially to understand sector level context on potential risk exposure. To reflect the uneven spread of risk and opportunity within risk forecasting, credit institutions should look closely at their approach to segmentation, combining macro data with demographic data to create a granular view of the local area impacts. Given the importance of industry dynamics, the re-introduction of automated decisioning is best done sector by sector on a progressive basis.

As the pandemic eases, lenders will need to take the pulse of their credit scoring models more often and adapt rapidly if their model is under-performing. To address uncertainty, models should be built based on shorter periods – say 15 to 50 days – and be broken down to sector and geography to generate triggers and flags.

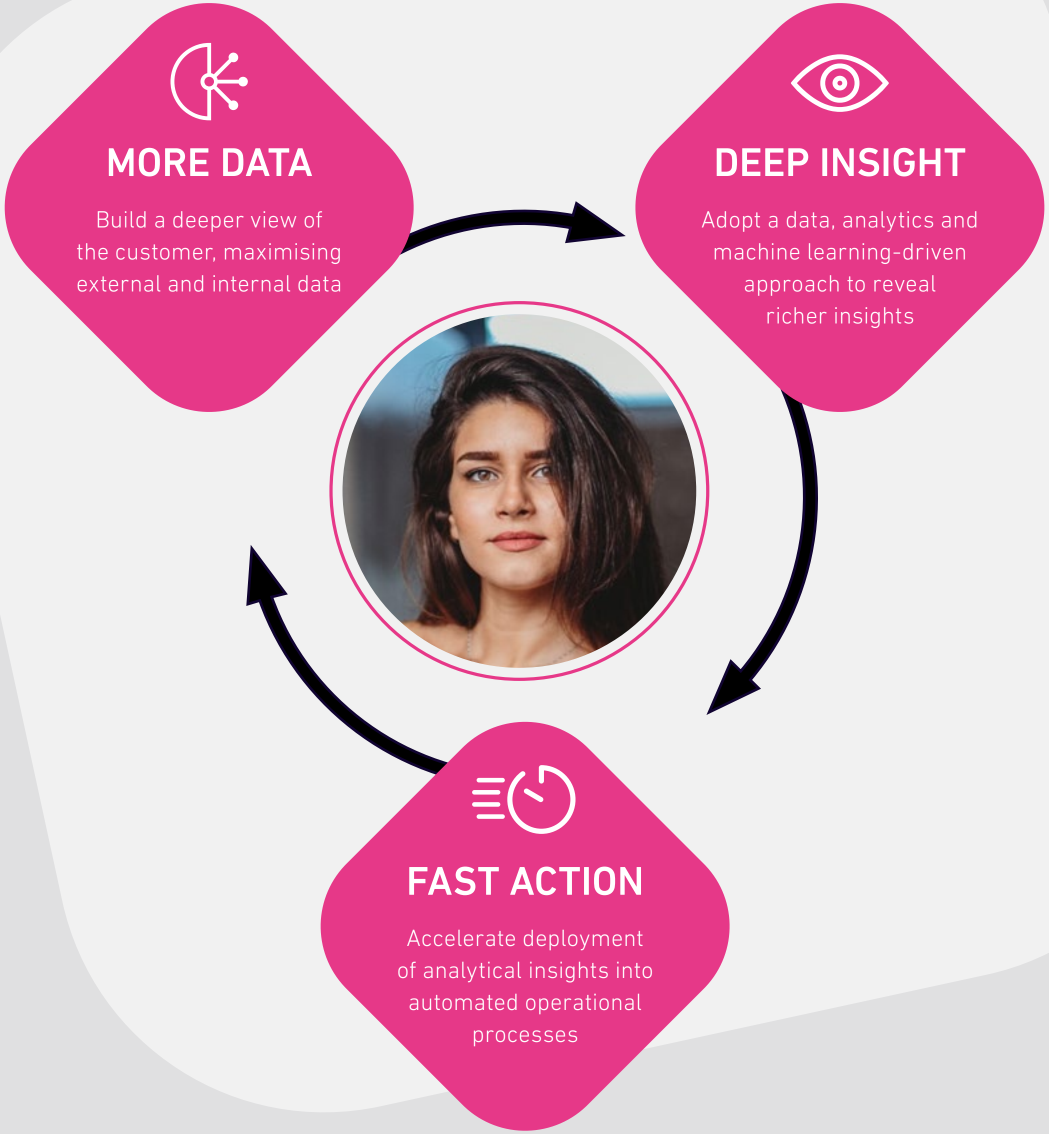


BECOMING MORE AGILE

To improve credit risk modelling in turbulent times, we're seeing more organisations utilise Machine Learning (ML) based scoring models. ML driven credit scoring models use more variables than traditional models to deliver a more complete view into a customer's behaviour. This will enable businesses to drill down into the details and interdependencies to understand customers, predict risk and value, and spot trends and patterns. ML models are much faster to recalibrate or rebuild compared to traditional models, which makes them more cost-effective.

The more accurate you can be when you lend the better. Using ML models will also help you take advantage of those new and alternative data sources, including transactional data from Open Banking as referenced earlier. Not only will this give you more confidence in the revised models, but the in-depth scoring allows you to improve marginal cut offs and as a result increase acceptance and reduce delinquency rates.

To understand the potential uplift, you can build multiple traditional and ML models and test performance before choosing which one to deploy. A scalable model development infrastructure that integrates data and advanced analytics will enable streamlined deployment into operational processes.



PREPARING FOR THE NEW NORMAL: TOP 3 TIPS

1

MONITOR THE HEALTH OF YOUR CREDIT SCORING MODELS MORE FREQUENTLY

Many of the predictive models that lenders rely on aren't stable enough to handle real-world disruptions, or recalibrated frequently enough to accurately assess risk in rapidly changing times. Monitoring models on a quarterly basis is no longer enough. You need to make practical, short-term adjustments. Increasing monitoring frequency and identifying when models needs updating sooner can have significant financial impact. Businesses could save millions of pounds in lost revenue or avoided credit losses.

2

BUILD MORE CONTEXT LED, SOPHISTICATED MODELS

The ability to combine macro-economic analysis at industry level with granular data at household level is going to enable more sophisticated models. This will enable credit providers to identify more accurately any potential changes in exposure and vulnerability. By incorporating a variety of data sources you can greatly increase the predictivity of models. For example, once categorised and analysed, transactional data provides a deeper understanding of a customer's income and expenditure behaviour that can't be seen by traditional data, which can be used to assess the recurrency of expenses over time to strengthen models and increase predictivity.

3

SET UP RAPID RECALIBRATION OR REBUILD OF MODELS

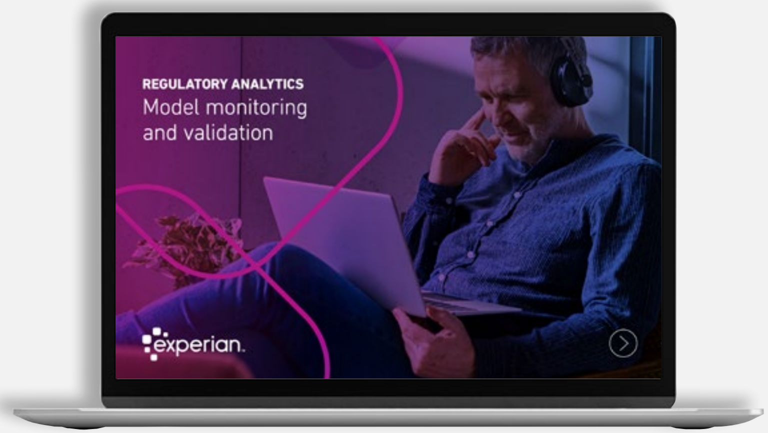
The ability to rapidly update models will be a key differentiator as businesses compete to grow their portfolios and manage losses during and in the aftermath of this pandemic. It's important to have the set up in place to actively work on recalibrating and rebuilding your models in a test environment, evaluate their impact, and be prepared to deploy. By increasing the frequency and efficiency of model monitoring and re-calibration, you can drive business outcomes with more impact than ever before.

HOW WE CAN HELP

Experian helps you grow your business by making fast, accurate lending decisions with confidence. Gain clarity through data and analytics, supporting you with expertise to optimise performance whilst ensuring fair and responsible lending.

We'll help you maximise effectiveness by enabling you to:

- **Access best-in-class data** to gain in-depth information about customers and their risk profile.
- **Integrate AI/ML at speed –** giving you a continuous understanding of opportunities and risks.
- **Monitor models and scenarios in real time,** enabling you to adapt in an instant.
- **Ensure regulatory compliance** with model monitoring and validation requirements
- **Turn insight into action –** accelerate deployment of models into live operational environment



To find out more, get in touch.

If you would like to find out more about how we can help optimise your scorecards and models, please contact your local Experian office or visit:

experianacademy.com

For guidance on model monitoring and validation, view our **latest whitepaper.**

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