The pieces of the jigsaw

This paper addresses some well recognised key trends in the UK economy, each of which contributes to a picture of the short and medium term business environment. It argues that when these pieces of the jigsaw are brought together the resultant picture should give rise to considerable concerns amongst lenders. It foresees a significant downturn, reviews the potential implications and identifies actions lenders should be taking now.

What's going on?

Cost of living
2022 has seen the British consumer faced with an unprecedented round of increases in their cost of living. These have been widely discussed and include higher energy bills, increased borrowing costs and record levels of taxation. The National Institute of Economic and Social Research (NIESR) forecast that 1.5 million households will struggle to pay their bills[1] . A Government Adviser recently suggested that the projected increase in inflation could exceed 10% and might run until 2024[2]. This will directly impact market interest rates and increase the cost of borrowing. Of interest to lenders is also the 16% disparity in inflation between the most and least affluent, the highest gap since 1998[3] .

Small business challenges
A healthy small business sector offers both a source of tax revenue for the exchequer and valuable employment opportunities. The loyalty of small businesses towards their staff benefits the exchequer through a greater reluctance on the part of proprietors to make them redundant, reducing unemployment costs and sustaining the spending power of employees in the sector.

However, the private business sector, and small businesses in particular, are facing a 'triple whammy'! They are also subject to many of the cost increases experienced by the consumer. Moreover, they will be further damaged when reduced spending and borrowing powers of consumers result in reduced sales. This may be sales from retail outlets, or it may be a drop off in house purchases, extensions and upgrades. By way of example, history has shown us the significant damage that can be done to jobs in the construction sector by a major downturn.

Additional Brexit related costs
Many British businesses have had to cope with the trading implications of Brexit, which is adding to their costs and, in some cases, reducing their ability to reach the profitable markets that they had dealt with historically. The Office for Budgetary Responsibility has already forecast a long term drop in Gross Domestic Product of around 4% resulting from

---

[1] https://www.niesr.ac.uk/blog/what-can-be-done-about-the-cost-of-living-crisis
[2] https://www.theguardian.com/business/2022/may/09/high-uk-inflation-could-last-for-years-rather-than-months-warns-economist
[3] https://www.theguardian.com/business/2022/may/22/gap-between-inflation-rates-for-richest-and-poorest-households-at-its-widest-in-16-years

Brexit. Brexit will also be the cause behind a 15% reduction in exports[4] . The practical implications of the break from the EU continue to arise and illustrate just how that drop will be caused. An important point to bear in mind for lenders is the incidence of the contraction. It will not be a tolerable 'haircut' across the business sector for all players. Rather, it will manifest itself as an existential threat to individual businesses, which have previously been benefiting from open borders.

Consequential increased risk of default

In consumer finance, the short term prospects for lenders looks potentially bleak. Able borrowers will be fewer if turnover in the retail and housing sector falls away. Many existing borrowers will have their ability to repay significantly reduced. Existing mortgage borrowers nearing the end of their fixed rate term will face higher interest rate options. Collections costs and write-offs will increase.

Bankers supporting the small business sector will have an equally uncomfortable time. According to the Federation of Small Business (FSB) Small Business Index, a majority of businesses are facing customer payment delays. Finance applications are at an all time low. For small businesses, credit approval rates have fallen, further reducing access to credit. Worryingly, 42% of successful applicants plan to use credit for cash flow rather than investment for growth[5].

Already noted is employer-employee loyalty in the small business sector, providing a hedge against job losses. However, it is only sustainable as a benefit for as long as the businesses are viable and exist. Over the last 20 years, the number of private businesses has steadily increased, but the trend reversed between 2020 and 2021: reductions of 6.5% overall, ranging from 17% for Northern Ireland to <1% in Wales. This reduction, accompanied by rising insolvencies, damages both the business lender and providers of consumer finance. Figures from the Office of National Statistics (ONS) show that whilst compulsory liquidations and administrations (England and Wales) are still at pre-pandemic levels, they are rising steadily[6]. In the first quarter of 2022, 137,000 enterprises closed their doors, with regional and sector disparities; voluntary insolvencies reached a 60 year high[7]. Whilst these numbers should be tempered (a "post COVID catch up" surge) and voluntary insolvency does not necessarily equate to financial problems, reducing numbers of businesses is a clear signal of fragility in the economy.

In response to higher anticipated default rates, the cost of economic and regulatory capital will rise. Unless central banks look to manage capital buffers, as per COVID, this will reduce lending capacity and thereby further constrain economic growth.

---

[4] https://obr.uk/forecasts-in-depth/the-economy-forecast/brexit-analysis/#assumptions
[5] https://www.fsb.org.uk/resources-page/lending-to-small-businesses-hits-all-time-low-new-study-finds-with-six-in-ten-impacted-by-late-payment.html
[6] https://www.gov.uk/government/statistics/monthly-insolvency-statistics-april-2022/commentary-monthly-insolvency-statistics-april-2022#main-messages-for-england-and-wales
[7] https://www.ft.com/content/ec8d97d3-ff39-4c7b-a6a2-ee7fc3234442

Overall, the above describes a scenario that could well arise from current trends. Prudent lenders will need to consider the potential implications for at least their short term approach, and also their longer term ambitions. Lenders now need to review their tactics in (at least) the following areas.

So what's to be done about it – *in summary?*

Marketing:
Build "impervious" segments: Focus on segments and products that will build good quality assets. E.g. consumers: look for income stability / growth potential – permanent contracts, guaranteed income; SME: steady insolvency rate industry types - professional activities, employment support services, financial and insurance activities.

Constrain vulnerable segments: Identify, understand and reduce exposure to those that carry the greatest susceptibility to any downturn. E.g. consumers: gig economy, self employed; SMEs: construction, housing, accommodation and food service sectors.

Product features: review to ensure that they remain appropriate in a significantly less favourable trading climate. E.g. the required loan-to-valuation (LTV) ratio and minimum monthly repayment levels; vehicle depreciation vs PCP balloon payment expectations.

Consumer education:
Inculcate and sustain good habits in the existing borrower. Incorporate education of applicants on responsible borrowing into communication programmes.

Credit risk assessment:
Understand the business assumptions and goals, defined by the board. Translate these into risk parameters and take judgemental action on cut offs and credit limit / loan amounts, if necessary, to deliver on board expectations. Create benchmarks to measure actual vs expected results. Ensure these benchmarks are sensitive to short term outcomes so that as deviations emerge, iterations of assumptions and policy changes are dynamic.

Reassess LTV ratios to protect lender and borrower from any downturn in the property and used car markets.

Focus on key sub-populations to support marketing effort in recruitment. Identify vulnerable segments quickly and feed this into the marketing cycle. E.g. public sector / pay freeze workers. Generally, in a downturn, public sector workers enjoy employment stability – but their income is forecast to fall behind inflation and private sector colleagues. They may therefore prove more vulnerable to default.

(For more ideas on techniques, refer https://www.scoreplus.com/assets/files/Great%20Expectations%20-%20Raising%20Standards%20in%20a%20Crisis%20-%20Helen%20McNab%20and%20Gerard%20Scallan%20ScorePlus.pdf)

Existing customer relationship management:
Understand existing customer worth and mirror marketing recruitment strategy to give cohesion of approach.

Identify and strengthen relationships with segments and products that will build good quality assets.

Identify and constrain "at risk" segments. E.g. vulnerable trade sectors and locations which may carry greater threats from their trade borrowers.

Ensure sensitive handling of initiatives. E.g. when eliminating unused capacity on a customer-by-customer basis to assist better management of the balance sheet.

Pre-empt issues and pre-define options for customers who may struggle to meet their repayment programme. E.g. pre-delinquency contact programmes; pre-determined payment holiday and refinancing options.

Communicate your initiatives regularly.

Collections counselling:
Identify borrowers with long term growth prospects that represent a source of future value. E.g. accounts where set-up costs have been fully amortised and which have been generating value for the business.

Should they experience difficulties, place emphasis on rehabilitation with dignity and goodwill. Ensure all forms of customer communications are modelled to this end. E.g. tone of correspondence and the point at which personal contact is established by a collector or counsellor.

Refer Wells Fargo - despite subsequent difficulties elsewhere in the business, Wells Fargo Bank exited the last economic crisis in the USA as a market leader amongst small businesses, as a result of its supportive relationship strategy.

Leveraging analytics:
Consumer credit trends tend to lead the economy. Use this to your advantage.

First signs: look at applicant profile. These are likely to decline – although this can be masked by more stringent qualifying criteria e.g. an increase in LTV.

Second signs: default rates greater than expected.

For new business, track outcomes from 4 months to get fastest possible reliable indicators. Respond to size and significance of change. Check the risk to score relationship to determine if the cut off needs changing.

For existing business, track delinquency using the vintage matrix. Focus on the older accounts. If their delinquency starts to rise, this is a sure sign of a portfolio wide issue, rather than new business.

Where there are multiple lending products, use cross product portfolio performance to inform credit strategies for the other products. Typically the credit card will lead the mortgage portfolio. During the global financial crisis, this lead time was as much as 10 months.

The bottom line

Across the market there will be a general acknowledgement that times are tough and growth is hard, if not impossible to achieve. The key strategic objective therefore is to ensure the quality of both existing assets, and any that are acquired anew. Lenders that do handle struggling customers in a sensitive and supportive manner will enjoy valuable reputational benefits, which will feed through to the bottom line.

A sound strategy and responsive reporting through the forthcoming difficult period will be a major contributor to a sustained return on investment. We are moving into an era, of either short or medium term, when the emphasis must be on the highest quality rather than quantity. Strategies and tactics to achieve this must be a priority in the business.

I am grateful to David Cavell, ScorePlus Associate, for setting out an understanding of the current economic challenges in the UK. His notes have been supplemented with publicly available statistics and references. Together, we have proposed a number of areas for lenders to address in response to these challenges. Feedback on this paper is welcome.

consultancy@scoreplus.com

Helen McNab
ScorePlus

Other useful references:

https://www.ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/19may2022

https://www.gov.uk/government/statistics/incorporated-companies-in-the-uk-january-to-march-2022/incorporated-companies-in-the-uk-january-to-march-2022

https://www.gov.uk/government/statistics/business-population-estimates-2021/business-population-estimates-for-the-uk-and-regions-2021-statistical-release-html