

UNSECURED PERSONAL LOANS AND CREDIT INSURANCE - THE RISK IMPLICATIONS

‘Cross subsidy’ occurs in many credit market segments and products - but in unsecured personal loans the impact of credit insurance penetration is examined and is significant.

UK regulators and consumerists seek ‘pricing’ transparency. in the prices consumers pay for banking and credit products. Competition investigations have often concluded that some financial institutions make excessive profits - at product level. However, pricing and fee structures have evolved and have become difficult to understand or unravel. The use of advanced risk measurement techniques has facilitated that its iRegulators have recently capped late payment credit card fees only to see other charges rise instead. A more recent study into the much more complex current account market will be in more depth with a view to doing the same. Interest rates, particularly for out of order current accounts and credit cards - risk-based pricing - and more significantly credit insurance - have come under increased scrutiny.

A current account is usually provided on a ‘free banking’ basis - but cross subsidy is involved. Large clearing and costs have to be covered though more The more obvious ones connected with ‘out of order’ accounts are recouped via late fees and higher APRs but this is being investigated. Indirect interest income for the banks is in decline - especially as Business banking was was investigated by the regulator who favoured are fees and interest on credit balances and this could be imposed on consumers. Lower income households could pay more unless subsidised. if introduced

‘Cross subsidy’ is most stark with unsecured loans where payment protection insurance has become a key added feature. Commission income from it combined with targeted interest rates helps make loans profitable - especially for finance houses seeking to compete with banks. The insurance take up rates affect how much extra risk can be taken.

‘The growth in personal loans was in part due to the insurance cross subsidy but also tPricing for risk’, low APRs for the deemed creditworthy and . This facilitated low cost processing and means that slightly more high risk customers still can be taken on - economically. Reductions in credit insurance penetration have occurred recently - due in part to adverse publicity and to tighter credit policy - and are already leading to

greater decline rates and some financial exclusion. The impact is substantial.

This Paper examines the specific financial impact on specific portfolios with different credit risk profiles and credit insurance penetrations. Scoring geared to handling a range of credit risks and complex financial calculations and assumptions are needed - as are multiple credit score cuts offs and models for profit, impairment and take-on costs.

The need for robust single and combined models is considered as there may have been weaknesses in past models. A sophisticated approach is needed in an area of complexity where errors have material financial consequences.

George Wilkinson

GWA

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