The New Mainstream

A new way to view the UK consumer credit market

A report by oplo

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Foreword

Consumer credit is a key feature of everyday life for the vast majority of people. In 2020, 81% of UK adults – or 42.5 million people – had used a form of regulated consumer credit within the past 12 months according to a major FCA survey[1].

Whether it be an overdraft, a credit card, car finance or a personal loan, consumer credit products have become a central feature of how households manage their day to day finances and how people pay for big purchases and major home improvements.

In many ways the UK has a highly competitive and innovative consumer credit market. Over recent years the market has seen the arrival of payday lenders, 'buy-now pay-later (BNPL)' products, as well as salary finance and other innovative schemes. While technology and changes in consumer behaviour appear to have led to rapid changes in the way consumers get access to and use credit.

These changes, however, illustrate that the market's traditional way of viewing customer profiles in the consumer credit market is quickly becoming out of date. Customer segments have been built around traditional lenders' own risk scorecards and customer profiling, failing to recognise the dynamic nature of consumers' lifestyles and behaviours.

At Oplo, we have long recognised the need for lenders to focus on customers' potential rather than the problems of the past. We understand customers' lifestyles and financial circumstances are constantly changing and that many customers are denied access to the best offers provided by traditional lenders as they don't fit neatly into their "prime" customer segment (or increasingly "super-prime").

We've known for a long time that millions of consumers don't meet traditional "prime" characteristics. Previous research found that 11-15 million customers alone may make up the traditional 'near prime' segment.

With traditional lenders increasingly looking to serve lower risk customers with new technology-driven propositions and the macro and micro economic impacts of Covid lockdowns, we believe there are far more customers being squeezed out by traditional banks. Many more are rising up the credit risk ladder, creating a "new mainstream" of customers who sit across both the near-prime and prime segments simply because of the fluctuating nature of their credit position.

This group could be as large as 26 million UK consumers based on the analysis in this report. That would represent the biggest challenge facing lenders in the UK today and a major shift in the way in which we view the dynamics of the UK's innovative credit market. But as well as a challenge, is this also an opportunity to reconsider how we view those customers by ditching the once traditional one-dimensional view and instead recognising the power of their potential?

Alex Mollart
Chief Executive Officer, Oplo

1. Financial Lives survey, FCA, February 2020.

What is the new mainstream consumer credit market?

Introduction

The UK consumer credit market is witnessing deep-rooted changes. The traditional way of looking at the consumer credit market through its three main categories of customers – prime, near-prime, sub-prime – no longer reflects the full picture of customer characteristics and behaviours.

The customary approach to industry segmentation does not account for some powerful underlying changes taking place within these segments, from the effects of the introduction of new policy to a wide range of long-term industry and consumer trends.

The **New Mainstream** is a new category that better reflects the millions of British consumers who straddle both the traditional prime and near-prime categories. These customers often find themselves moving regularly between these two traditional categories, or as is increasingly the case, find themselves left unserved by traditional lenders as credit criteria are becoming increasingly rigid, even though these customers may demonstrate many of the traditional characteristics of a prime customer.

This new category covers millions of consumer borrowers and provides a much more realistic picture of the financial situation of borrowers.

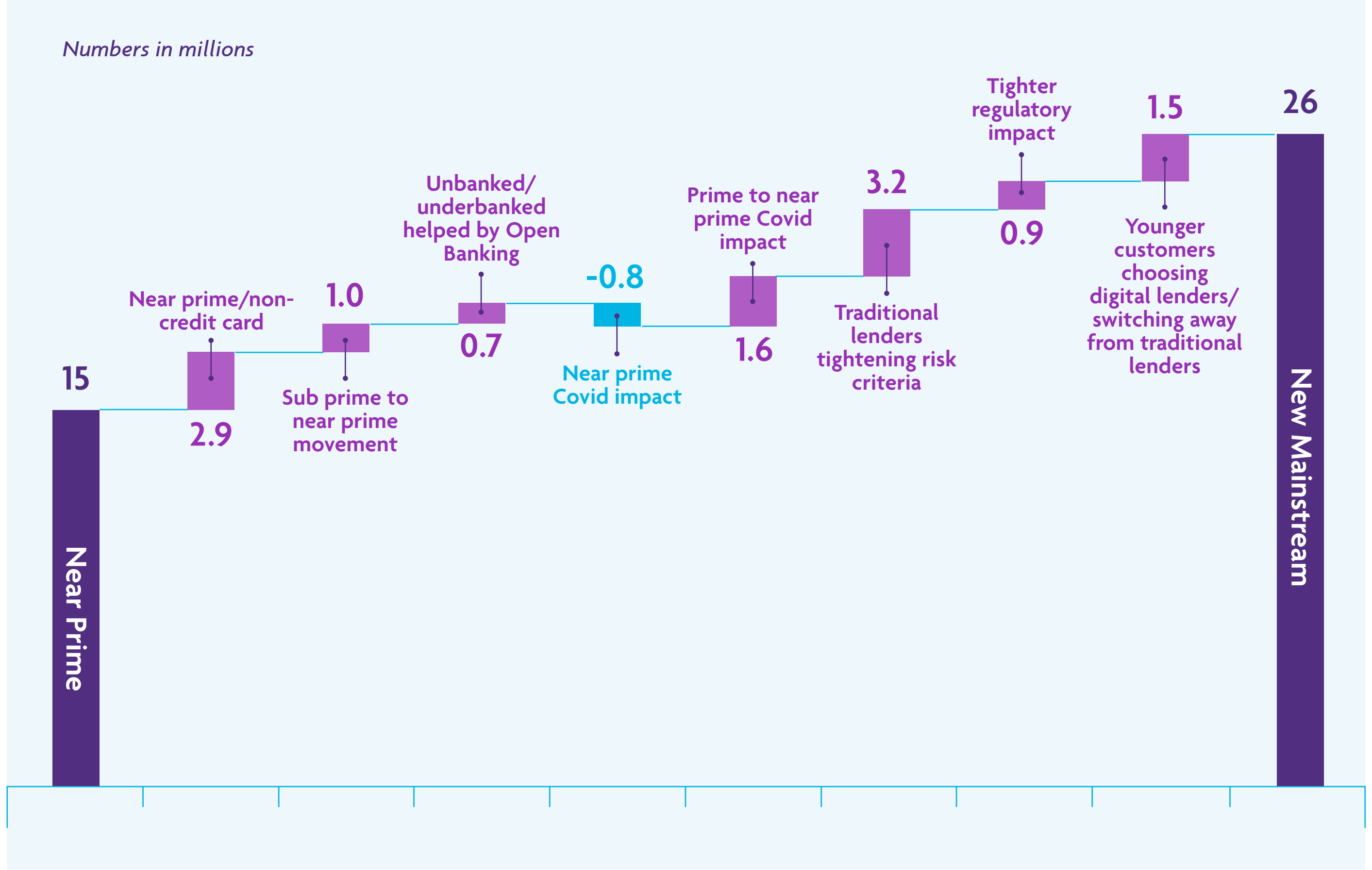
The **New Mainstream** represents an important shift for consumers – and policy-makers – across the entire credit spectrum, as this is quickly proving to be the segment where the vast majority of personal credit customers are going to be served going forward.

Our analysis suggests between 20 – 26 million consumers fall within the 'new mainstream' category. This is almost twice as many customers previously thought to make up the 'near-prime' category[2] and is the biggest opportunity in the UK consumer credit market.

2. Banking the under-banked: the growing demand for near-prime credit, PwC, 2015

The New Mainstream Market

High Range (full analysis in Key Findings section on page 8)



The traditional view on the near-prime market

The UK mainstream banks[3] still have a very static view of customer segments: a customer is either prime and interesting because of their low risk, or not. Even better if said customer is super-prime, which is where most incumbent banks now focus their attention. These lenders have been quietly yet quantifiably reducing their risk appetite and tightening their lending criteria over the past few years. This trend has been particularly visible since the beginning of the Covid-19 pandemic in the UK in 2020[4].

What this means in practice is that mainstream banks are increasingly turning their attention away from mainstream customers and many UK consumers will find it increasingly difficult to borrow from traditional lenders. This is best exemplified by investigating the credit scores required to apply for consumer credit – a customer needs to have a better than average credit score, demonstrating more super prime characteristics, to secure a product with one of the traditional lenders.

The main issue lies with the fact that the average credit score in the UK is *"fair"* according to the major credit rating agencies[5], which sits between *"poor"* and *"good"*. It should mean that a customer would be accepted and offered reasonable interest rates, together with what is likely to be a low credit limit.

But in reality, it is nearly impossible for a customer to obtain a credit product with a traditional bank with a fair credit score. Providers traditionally seen as serving the mainstream are in fact not catering for the mainstream's needs.

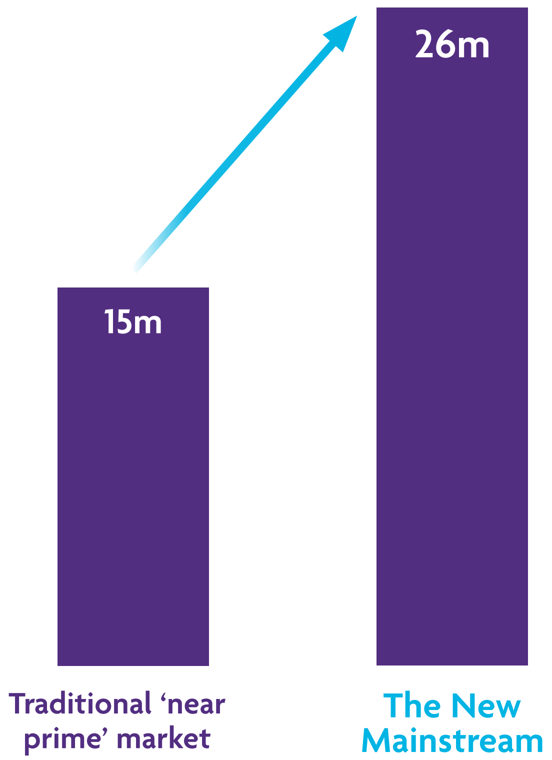
3. Barclays UK, Co-operative Bank, HSBC UK, Lloyds Banking Group, Nationwide Building Society, NatWest Group, Santander, TSB, and Virgin Money.
4. The Woolard Review, FCA, February 2021.
5. TransUnion, Experian, Equifax
6. Banking the under-banked: the growing demand for near-prime credit, PwC, 2015

What used to be described as the near-prime credit segment[6] is wider than previously thought and encompasses a greater number of customers. This is because both the prime and sub-prime segments are shrinking, but for different reasons.

Prime customers are left behind by traditional lenders who are targeting more affluent and low-risk super prime customers whilst some have been impacted by the current macro-economic environment.

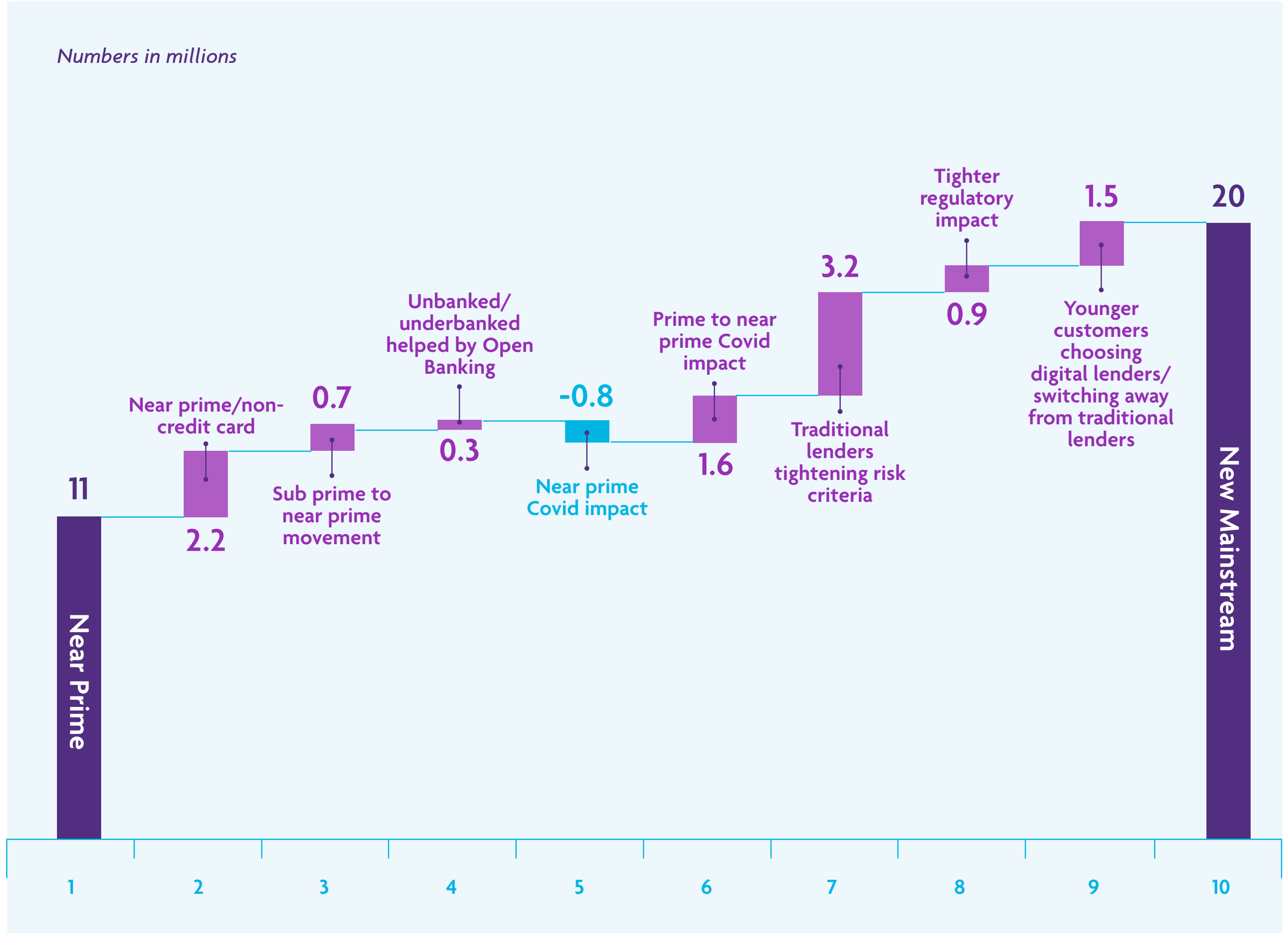
Meanwhile, we are seeing the traditional near-prime market expand as sizeable numbers of sub-prime customers make meaningful moves up the credit ladder through the use of better, more responsible financial products that help improve their overall financial profiles.

The resulting impact is the creation of a larger middle ground – what we define as the **New Mainstream.**

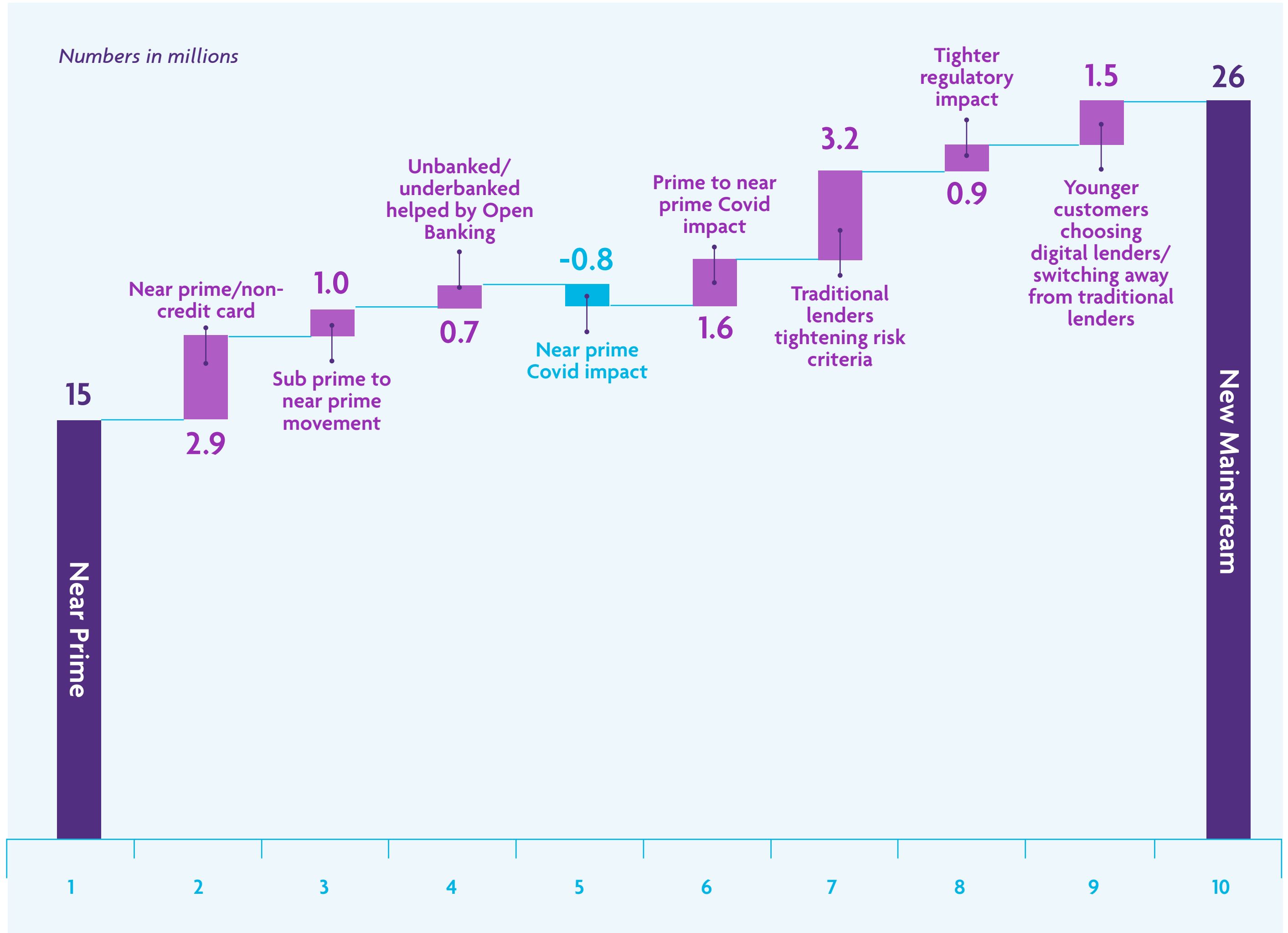


Key findings

The New Mainstream Market - Low Range



The New Mainstream Market - High Range



Our analysis of the market is modelled around a number of observable changes in the market:

1. Between 11 million and 15 million customers that are part of what is considered to be the core near-prime segment for credit cards[7].

2. 2.2 million to 2.9 million customers that do not have a credit card but have another form of near-prime credit product[8].

3. 0.7 million to 1.0 million sub-prime customers that are susceptible to move to the near-prime segment through conversion from high-rate consumer credit products to better products that improve their financial profile.

4. 0.3 million to 0.7 million of customers that are currently unbanked or under-banked that can be better included through leveraging Open Banking and other means[9, 10].

5. 0.8 million near-prime customers that will ultimately be impacted by Covid-19.

6. 1.6 million prime customers impacted by Covid-19, similar to near-prime customers but assumed to proportionally affect them more due to stricter credit eligibility at mainstream lenders.

7. 3.2 million prime customers at risk of being left behind by traditional lenders that have tightened their lending criteria and want to focus on the more affluent.

8. 0.9 million prime customers impacted by recent regulation changes that will drive further reporting of payments incidents from BNPL schemes[11].

9. 1.5 million customers, mostly younger demographics, that ultimately will be opting not to go for traditional lenders due to poor digital customer experience and other criteria[12].

10. **The New Mainstream Market comprises of 20 million to 26 million customers.**

7. Sizing the UK Near Prime Credit Card Market, PwC, January 2016.
8. Mintel Unsecured Loans, January 2021.
9. 'Financial Inclusion: Annual Monitoring Report 2020', Stephen McKay and Karen Rowlingson, 2020.
10. 'Basic Bank Accounts July 2018 to June 2019', HMT, December 2019.
11. The Woolard Review, FCA, February 2021.
12. Assumption based on significantly higher usage of digital credit by younger generations (under 34s).

A changing consumer credit landscape

There are several factors contribution to significant change in the way that the UK consumer credit will be evaluated and understood.

1. Macro-economic trends

The impact of the Covid-19 pandemic is not yet showing in credit score changes across the UK, with delinquency rates still running at a recent low[13], even though it is forecast to have a devastating impact on household finances[14]. This is due to payment holidays and freezes, as well as various government schemes, including the Coronavirus Job Retention Scheme, that have softened the economic blow of the pandemic and have postponed its negative effects. This pandemic-induced economic crisis will actually push more prime customers into the near-prime market segment, as income stress has been wide-ranging across the population. Credit scores cannot be relied on to identify Covid-19 impacts: the repercussions have been uniform throughout the UK population and have not proven to be more significant in the lower segments of the credit spectrum.

Early indications show that we will eventually witness a deteriorated credit environment, as signalled by the income shocks across the entire adult population. Moreover, delinquency rates and balance write-offs have not deteriorated over the period, but under the surface, the emerging problem looms. The decline in write-offs has coincided with the FCA instructing lenders to offer payment holidays and other support for borrowers in response to Covid-19[15]. The main concern is that the reduction in write-offs seen over the last year will prove to be a temporary calm before the storm when support measures are withdrawn.

And a storm there will be. Nearly 11 million people have borrowed for everyday spending since the beginning of the pandemic, including 2.8 million who have used high cost credit to make ends meet[16]. The Coronavirus Job Retention Scheme (currently due to end in October 2021) is likely to result in unemployment peaking at 6.5%[17]. Accordingly, this will increase the pressure on household finances and therefore the unsecured personal lending market.

13. UK random 10M sample, delinquency excludes historical defaults, TransUnion 2021.
14. Financial Inclusion Monitor 2020, University of Birmingham, October 2020.
15. Unsecured Loans UK, Mintel, January 2021.
16. The Money Statistics, The Money Charity, April 2021.
17. Overview of the March 2021 Economic and fiscal outlook, Office for Budget Responsibility, March 2021.

2. Industry trends

The Covid-19 pandemic is shaking the consumer credit market at a time of strong underlying trends. Traditional lenders still have a very fixed view of consumer segmentation - super-prime, prime, near-prime, sub-prime - with an increased focus on the first two segments, which are actually shrinking mainly because of these same high street lenders.

Incumbent banks have been tightening their risk criteria for years, slowly leaving behind traditional prime customers. This trend has accelerated during the Covid-19 pandemic[18]. Incumbent lenders are increasingly focusing on the super-prime and prime segments: a customer needs a good credit score to obtain a consumer credit product with one of the traditional lenders. This raises a number of issues given that the average credit score in the UK is fair[19], meaning that the average customer cannot obtain a credit product with what is assumed to be a mainstream lender[20].

Traditional providers are therefore not catering for the mainstream's needs. This has been accentuated as the pandemic continued: lenders have concentrated their attention on existing customers amid current difficulties, as evidenced by advertising spend by traditional lenders for consumer credit falling massively over the period.

Another strong background trend is the fact that more customers are moving from what is considered to be the sub-prime segment to the near-prime segment. This is happening because these customers are slowly but surely being offered alternatives to high-cost credit, which in turn is improving their credit scores and overall financial positions.

The high-cost credit market has clearly been shaken in recent years, ever since the FCA took on the responsibility for regulating consumer credit in 2015. The increased regulatory pressures culminated in the Woolard Review into the unsecured credit market published in February 2021. Before that, the FCA multi-firm review of re-lending by high-cost lenders (e.g. guarantor loans) in August 2020 was already challenging the business of certain lenders in the sub-prime segment and calling for further financial inclusion through better practices.

Overall, this is positive for sub-prime customers, who in the future will have better access to alternatives that will genuinely help them improve their financial

18. The Woolard Review, FCA, February 2021.
19. Credit Score Capital of the UK, MoneySuperMarket, October 2020.
20. Comparison analysis based on current credit rating requirements by mainstream credit card providers.

situations. This will result in a shrinking population of sub-prime customers who will move into the **New Mainstream.** For instance, micro-loans are challenging the payday lending industry and helping consumers bridge the often unavoidable gaps between pay cheques, without being stuck in a vicious cycle of high-rate credit[21]. Credit unions could also start offering alternatives to payday lenders and other high-rate credit providers.

Furthermore, the introduction of novel practices and technology such as Open Banking could help bring the under-banked and unbanked into the **New Mainstream.** There are currently around 1 million unbanked in the UK[22], that is people with no current accounts or alternative e-money accounts. This has reduced from 1.5 million in 2015[23], partly due to the introduction of basic bank accounts by the 9 largest personal current account providers at the beginning of 2016[24], but also the introduction of alternative neobanks and e-money accounts. However, it is still a very large number of people that are excluded from the mainstream financial system. But beyond that, there are 7.5 million adults with basic bank accounts, which means customers that cannot access normal forms of credit: 7.8 million people, that is 15% of total UK adults, either chose not to access credit or do not have access to credit[25].

The lending opportunity through Open Banking is therefore significant: accessing accurate and detailed personal data that the technology provides can help lenders make better underwriting decisions for consumers who are more likely to be financially excluded at present. This has the potential to bring more customers into the **New Mainstream.**

At the other end of the credit spectrum, prime customers are at risk of fallout from that category due to the increased use of unregulated consumer credit. Buy Now Pay Later (BNPL) products have boomed in recent years, with 15 million people choosing this type of product in the past 12 months[26]. However, pre pandemic, almost half of buy-now pay-layer (BNPL) users had defaulted on a repayment at least once[27]. The fact that these products are to be brought within the regulatory perimeter of the FCA[28] means that the reporting of incidents is likely to be more frequent – in particular the reporting of arrears, default and forbearance. This could have a disastrous effect on the credit score of prime customers as two-thirds of BNPL customers do not believe that it is an actual form of consumer credit[14] that could eventually impact their credit score. Tightened eligibility criteria at traditional lenders means that these customers will join the **New Mainstream.**

21. Comperemedia 2021 Financial Services Trends.
22. HMT Financial Inclusion Report, November 2020.
23. Financial Inclusion Commission, 2015.
24. Under the terms of the Payment Accounts Regulations 2015.
25. The Money Statistics, The Money Charity, April 2021.
26. Citizens Advice, April 2021.
27. Serious concerns over 'Buy Now Pay Later' credit during lockdown, Comparethemarket, May 2020.
28. The Woolard Review, FCA, February 2021.

3. Changing lifestyles and consumer preferences

Work dynamics are changing. In 2019, 14% of workers were self-employed in the UK compared to 8% in 1975[29]. Although there has been a temporary slump during Covid-19, many enter self-employment from unemployment or after a period of inactivity, which means that it will likely pick-up again after the crisis. Traditional credit scoring makes it harder for this cohort of the population to access good consumer credit products. They are therefore attracted by alternatives to traditional lenders.

Customers are also looking for more when it comes to financial services – something that has accelerated during the pandemic. Visits to bank branches fell drastically over the past 18 months and are not expected to recover. Furthermore, customers are anticipating exceptional digital experience, expectations set within financial services (e.g. fintechs and neobanks) and outside of it (e.g. Uber, Amazon). This is something that high street banks tend to struggle with given their comparatively poor digital capabilities.

This is particularly true for the younger demographic: digital credit facilities are becoming mainstream among this target demographic, with more than double the usage than the rest of the population[30]. This will lead to more customers choosing to opt for alternative lenders, irrespective of their position on the credit spectrum.

Furthermore, beyond customer experience, what customers really value is the trust that they have in the financial institution. This explains why the majority of customers still take out a loan with their existing provider[27]. However, consumers remain reluctant to use credit, even though they remain confident that they would have their application accepted, because they are concerned that loan providers do not tend to lend responsibly. There is a clear trust issue.

The role of trust in the decision process is in addition, understandably, to a low / competitively priced interest rate which is an important factor when choosing a lender. However, the new FCA rules on overdraft charges introduced in April 2020 led to a big increase in interest rates; the average rate for an overdraft now stands at 33% APR[31], which is pushing customers to look for alternative lenders.

A majority of consumers believe that responsible lenders can be a force for good in society[32]. However, trust is not a given in the consumer credit sector: people tend not to trust loan providers to lend responsibly[33]. The industry has suffered from the damaging practice of high-cost credit companies over the past few years, which led people to believe that lenders are more interested in maximising profits than lending responsibly. There will be clear winners and losers post-pandemic between the lenders that are perceived to be socially responsible and the ones that are not.

29. What does the rise of self-employment tell us about the UK labour market, IFS, November 2020.
30. Unsecured Loans UK, Mintel, January 2021.
31. The Money Statistics, The Money Charity, April 2021.
32. Consumers Attitudes towards Debt: Impact of COVID-19 – UK, Mintel, July 2020.
33. Unsecured Loans UK, Mintel, January 2021.

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