Experian Risk Radar Report

2023

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Executive summary

Australia has entered a heightened credit risk environment with the majority of risk leaders reporting increased rates of hardship and defaults and almost all predicting a tougher 12 months ahead. To navigate their organisations through the volatile economic environment, the pressure is on risk strategy. To take a more proactive approach to managing customers and the internal and external risks to their loan book, risk leaders are looking to increase investment in data and technology.

These are the key findings from our third annual Risk Radar report, which gathered in-depth insights from 75 Australian risk leaders across the financial services and telecommunications sectors. In combination with global research commissioned from Forrester of 889 business leaders (including 66 from Australia) and insights from the Experian credit bureau, this report provides the most robust picture of the current state of credit risk management and likely trends for the year ahead.

The report highlights the focus of risk experts on supporting customers during a tough economic market, while also prioritising robust hardship management. In the face of challenges like the higher interest rate environment and escalating cost-of-living, consumers, lenders and risk experts share the task of management and improving financial wellbeing to address growing concerns in the year ahead.

"Credit risk performance has been strong for so long that senior management may underestimate the potential scale of losses if a major recession occurred. Focus is mainly on fraud / scam losses."

– Risk leader from a West Australian headquartered bank

Higher interest rates influencing risk strategy

Income and expenditure have become more volatile due to economic factors such as rising interest rates, inflation and the impact of increasing cost-of-living, which risk leaders identified as a major influence on customer affordability and risk strategy in the previous year.

The economic climate forced some lenders to change tack and focus their attention on supporting their existing customers, rather than generate new business and growth.

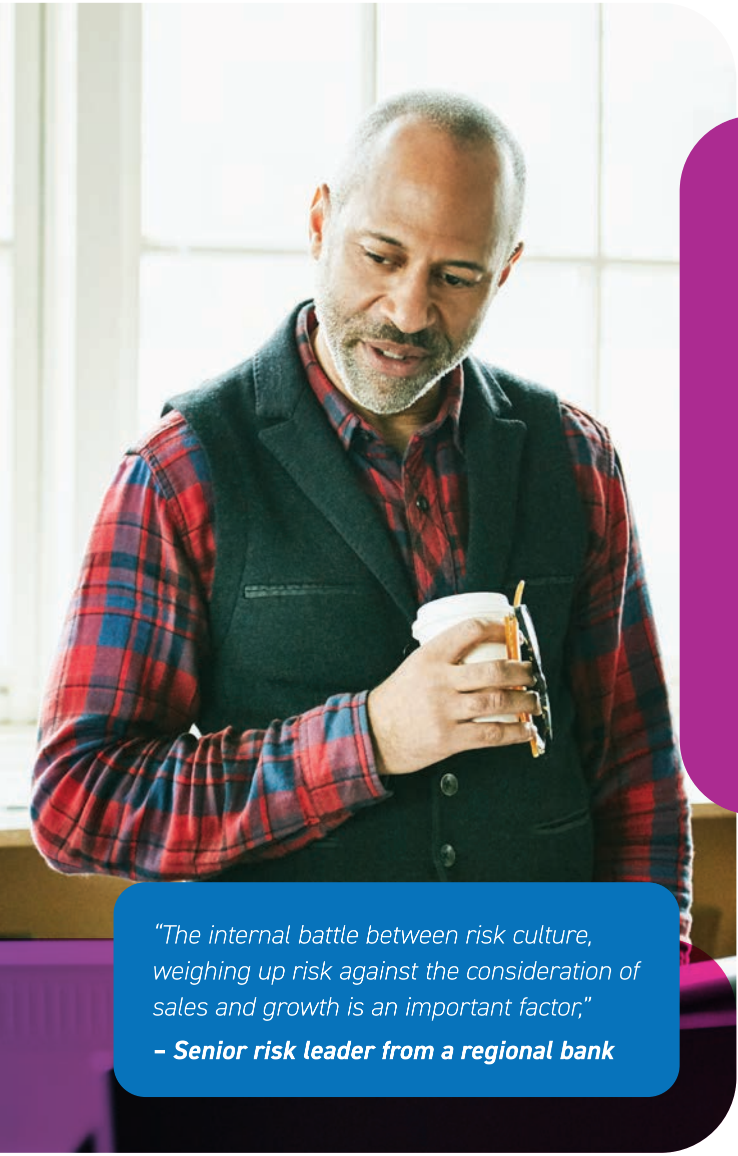
The key external influences putting pressure on risk strategy were changes to regulation, such as changes to Buy Now Pay Later (BNPL), Comprehensive Credit Reporting (CCR) and Consumer Data Right (CDR), a focus on compliance (such as Anti-Money Laundering (AML) and responsible lending) and the fluctuating property market.

These factors brought into focus a need to better understand customer financial health and affordability of lending products as well as capacity to repay their loans.

"The economic environment changed the priorities within the business to focus on existing customers rather than new business."

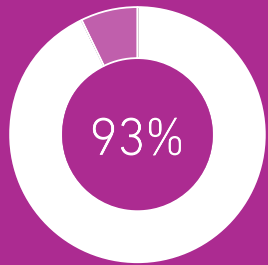
– Joanne Edwards, Chief Risk and Data Officer, Wisr Finance

Risk leaders see heightened risks

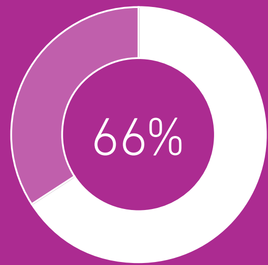


> *"The internal battle between risk culture, weighing up risk against the consideration of sales and growth is an important factor,"*
>
> ***– Senior risk leader from a regional bank***

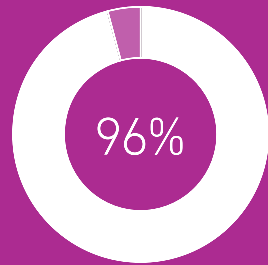
Risk leaders are already seeing an increase in risk factors across their organisations in recent months and the vast majority are predicting it is only likely to get more challenging in 2024.



According to most risk leaders **(93%)**, Australia will see higher credit stress, missed repayments and delinquencies in the next 12 months.



Two thirds **(66%)** say they have already seen an increased risk of consumer defaults and hardship in the last six months, while **23%** believe this is part of an upward trend over the last two years. Less than 1 in 10 risk leaders are optimistic about the current environment, not recording any greater risks to their organisation in the current market.



Almost all respondents **(96%)** said it was likely or very likely that customers will experience increased levels of hardship and defaults in the next 12 months.

While lenders are navigating the heightened credit risk environment, they are also conscious that their underlying loan book remains strong, and most Australians remain well prepared to manage the dual impacts of rising inflation and further rises in interest rates on their repayments. As the Reserve Bank of Australia (RBA) said in its most recent assessment of financial stability in October 2023, "Most Australian households and businesses remain well placed to manage the impact of high inflation and higher interest rates given the strength of the labour market and sizeable savings buffers. The vast majority of Australian borrowers have continued to service their debts in the face of higher inflation and interest rates."

Tough market for borrowers

The intensified risk landscape has also led to lenders tightening their lending criteria and assessments. About half of risk leaders (45%) in Australia acknowledged that it's tougher for credit applicants to get approval in this market, with almost 1 in 3 (32%) saying they had tightened their lending given cost of living hardships.

As a result, risk leaders are looking inward, with proactive customer management identified as a top priority for lenders with 3 in 5 having effective processes in place to identify customers in financial stress.

45%

About half of risk leaders **(45%)** in Australia acknowledged that it's tougher for credit applicants to get approval in this market.

32%

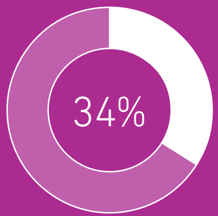
Almost 1 in 3 **(32%)** say they had tightened their lending given cost of living hardships.

"The velocity of funding cost increases has been challenging to manage in our competitive market along with the reality of inflationary pressures on consumers' appetite to borrow and ability to repay without overburdening."

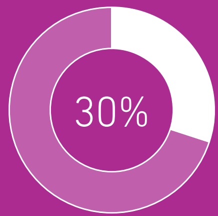
– Risk management decision maker from an online lender

Interest rate cliffs more like shock waves

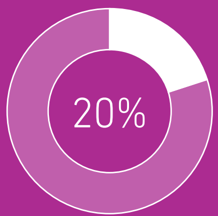
Australian risk leaders agree that the much-publicised concerns about "interest rate cliffs", where borrowers coming off interest-only loans struggle to manage their higher repayments, is a justified cause for concern. However, they disagree on when and how many spikes we'll see.



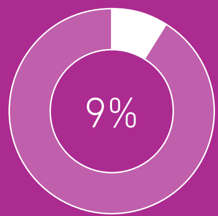
believe Australia has already started to experience multiple waves of increased borrower hardship



believe Australia will soon experience multiple waves of increased borrower hardship

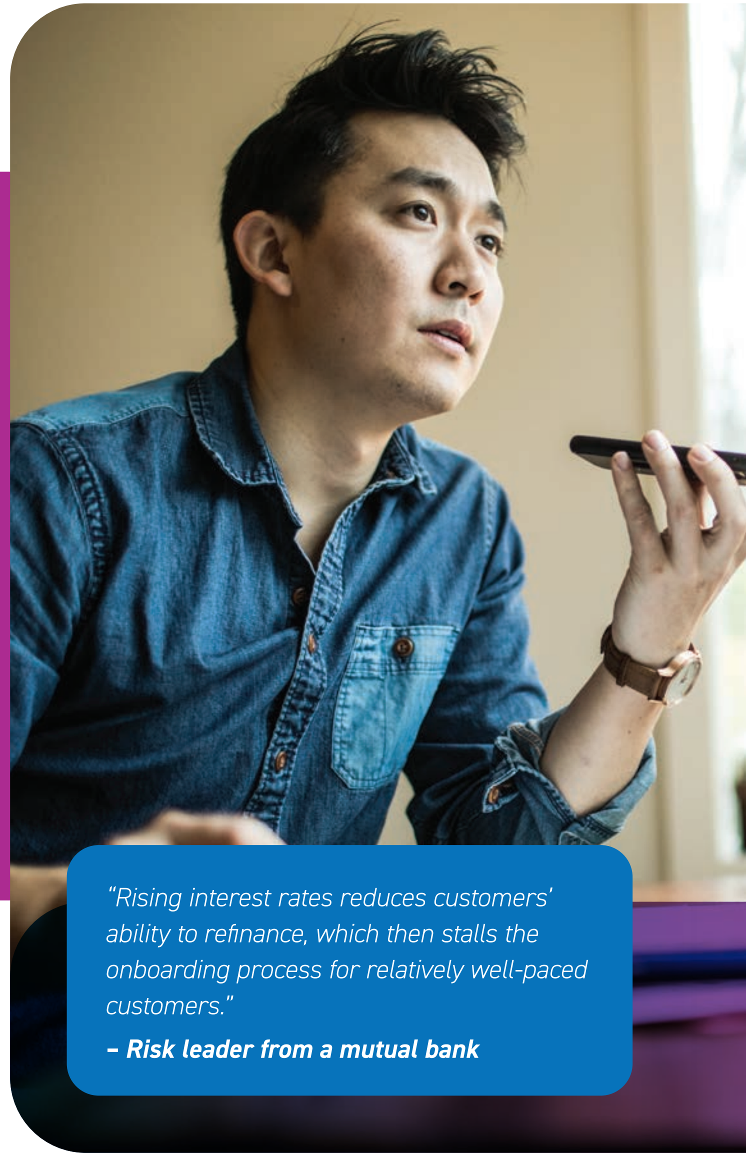


believe Australia has already experienced an interest rate cliff



believe that Australian borrowers won't experience a cliff, wave or waves of hardship

Positively, almost half of risk leaders believe that their risk strategy and customer management processes can have a real impact on the financial wellbeing of their customers. Almost half of risk leaders (48%) said that lenders could avoid their customers experiencing a hardship cliff if they had a better approach to proactive customer management.



"Rising interest rates reduces customers' ability to refinance, which then stalls the onboarding process for relatively well-paced customers."

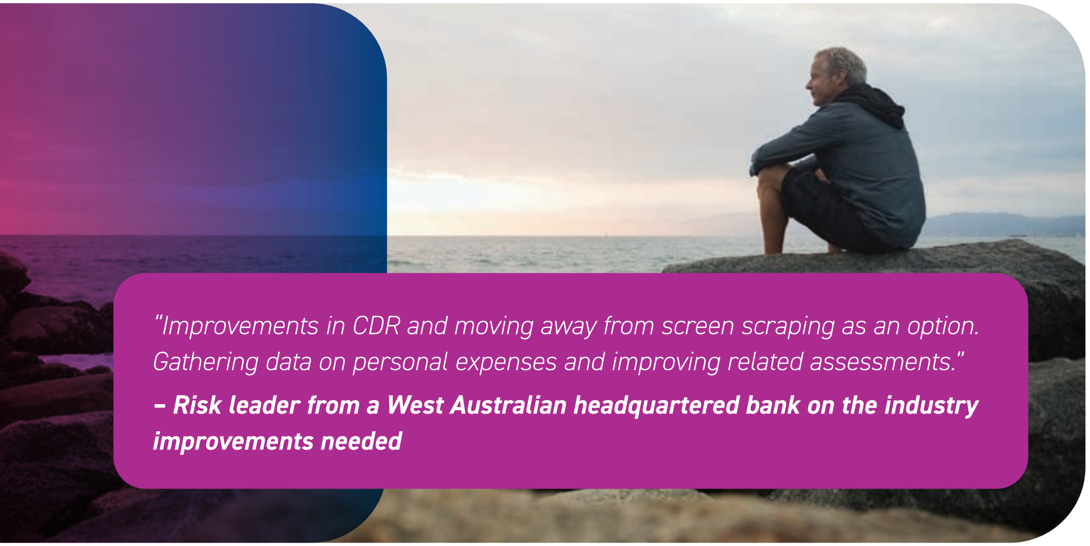
– Risk leader from a mutual bank

Volatile vintage

Demonstrating the urgency for lenders to enhance their risk assessments is the latest analysis of credit stress from the Experian credit bureau. The research shows credit stress and rates of missed repayments are getting worse with every new generation of borrower.

The levels of home loan repayment arrears for borrowers have increased significantly for accounts that originated in the last decade, with borrowers that took out a home loan since 2019 three times more likely to miss repayments than those that took out a home loan before 2015 and twice as likely as home loans opened between 2016 and 2019.

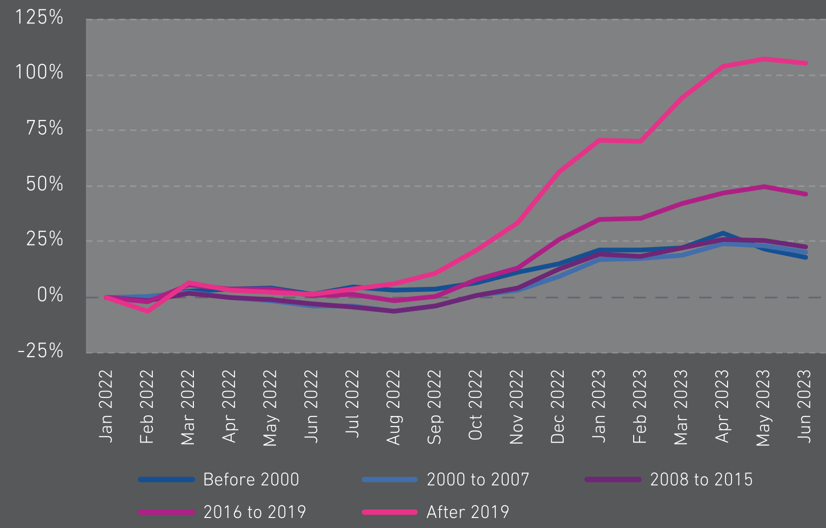
Looking deeper at the performance of new home loans in the last two years, we can see that the levels of missed repayments and arrears is getting progressively worse, in a shorter period of time for borrowers each quarter. Within five months more than 1 in 200 new home loans opened in Q4 2022 were in arrears, compared to it taking 24 months to reach similar levels of arrears for home loans opened in Q2 2021.



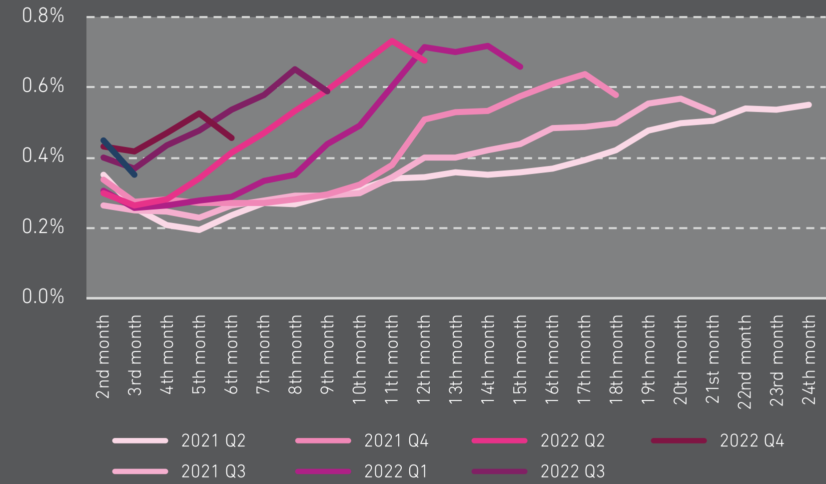
"Improvements in CDR and moving away from screen scraping as an option. Gathering data on personal expenses and improving related assessments."

– Risk leader from a West Australian headquartered bank on the industry improvements needed

Change in arrears (1+) since January 2022 by account age



Early stage performance of home loans by vintage



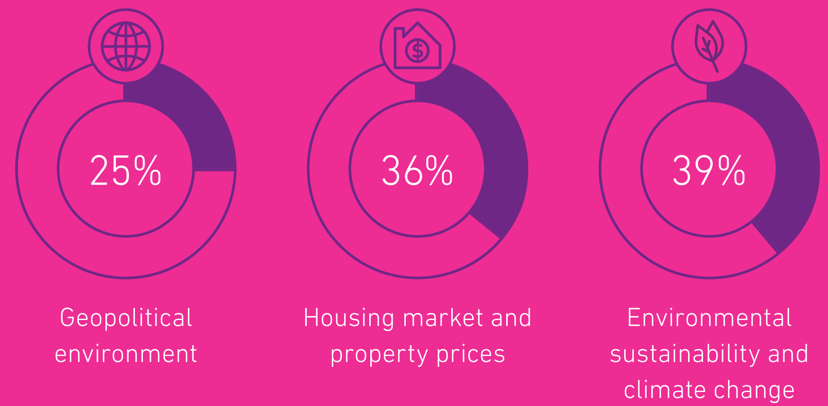
Multiple risk factors at play

It's not the first time the Australian credit industry has had to navigate a volatile market where the industry had to quickly adapt to the impacts of the pandemic on borrowers whose financial situations changed rapidly and without warning.

More than two thirds (68%) of risk leaders believe that those same characteristics apply today and recognise that an individual's financial circumstances can change very quickly in the current market. As a result, more than half (57%) have strengthened their risk measures in recent times to better protect their organisation.

The top concerns for risk leaders influencing current risk strategy included:

Lowest concerns were:



"[The biggest influence on risk strategy over the last year] is enriched data from CCR and credit scoring. More data available on counterparties, and ability to have lower speed to decision and higher quality."

– Cemal Akgul, Head of Risk & Collections, IQumulate Premium Funding

Risk leaders believe they are doing okay

While it's not clear how much worse the economic storm might get or how long it will take for the clouds to dissipate, most risk leaders think they are doing ok and feel well prepared. Four out of five (80%) risk leaders believe they have done a good job with their organisation's risk strategy and performance in the last year.

While 27% gave themselves the top mark of "very good", 20% saw room for improvement and no risk leader rated their organisation as poor or very poor.

Despite the need to improve data analytics, most risk leaders believe their organisation's risk processes are working well. Active customer management was identified as the area that needed the most attention while the best performing was customer acquisition.

"There needs to be improvements made to the CDR and Open Banking. The uptake is very low, so the value derived by incorporating this into lending decisions / processes is very low."

– Risk leader, credit union

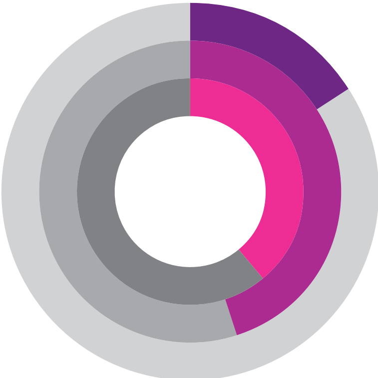
89% said their responsible customer acquisition processes were good or very good

72% said their management of hardship and collections were good or very good

66% said their customer management was good or very good

Managing hardship doesn't have to be hard

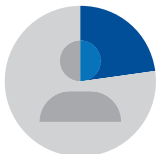
Assessing an individual's financial health accurately at the outset of a relationship can be challenging enough, but it becomes even more complex when an individual's financial situation undergoes changes during the term or contract. To protect the customer and the loan book, it's just as important to monitor a consumer's ability to afford a loan throughout the life of the agreement to minimise financial stress and maximise financial wellbeing.

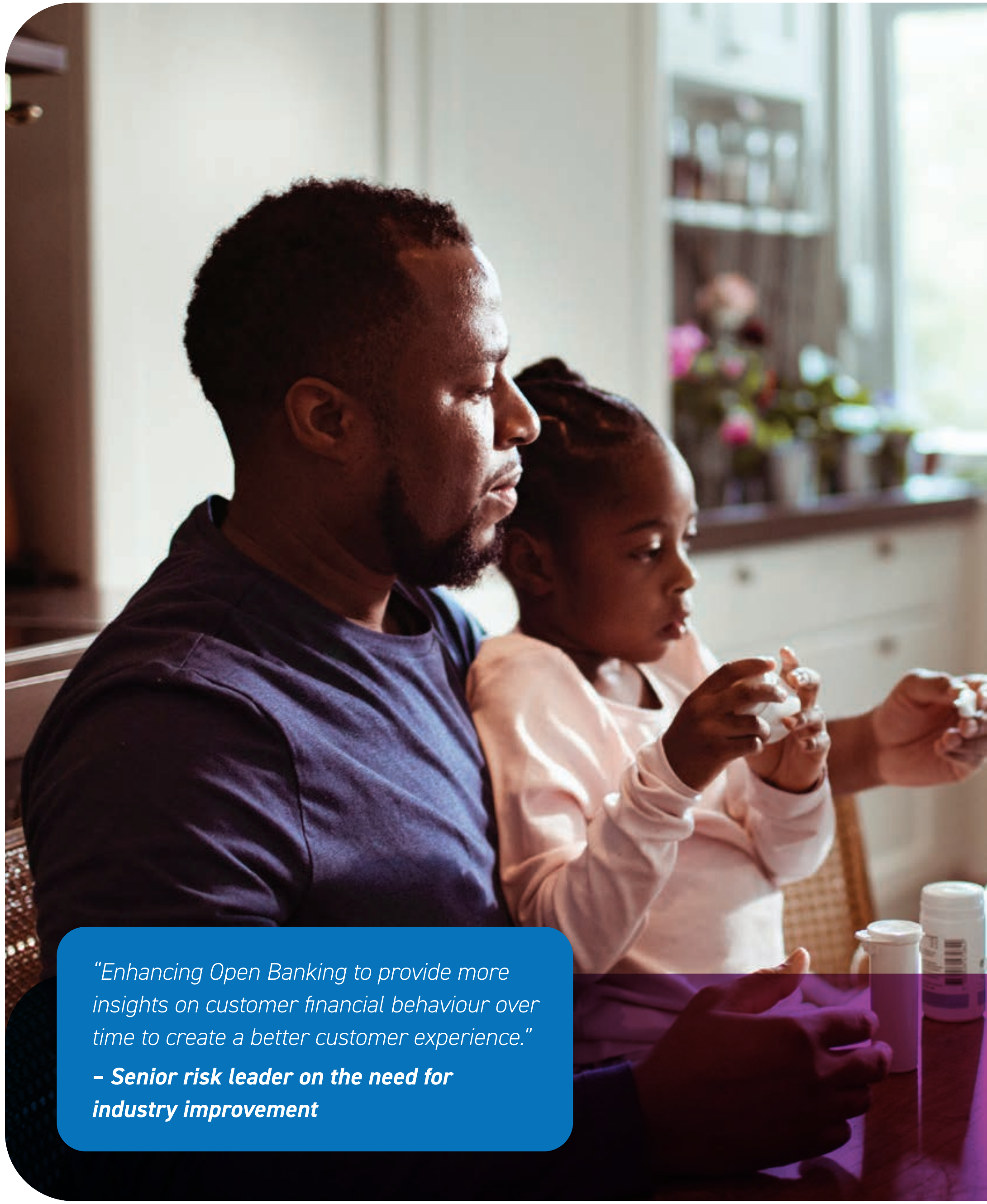


Despite the elevated risk environment, just **16%** of risk leaders said their organisation was highly effective at proactively identifying customers in financial stress, with **45%** sharing that they're moderately effective. However almost 2 in 5 (**39%**) do not rate their ability to proactively identify customers in financial stress at all (23% slightly effective and 16% ineffective).

Just over half of risk leaders (55%) said the earliest their organisation could reliably identify that a customer is in a position of financial stress was not until they missed a repayment, which was slightly higher than risk leaders who reported the same in 2022 (53%).

Surprisingly, almost a quarter (23%) of lenders do not know if a customer is in financial stress until they are contacted.





"Enhancing Open Banking to provide more insights on customer financial behaviour over time to create a better customer experience."

– Senior risk leader on the need for industry improvement

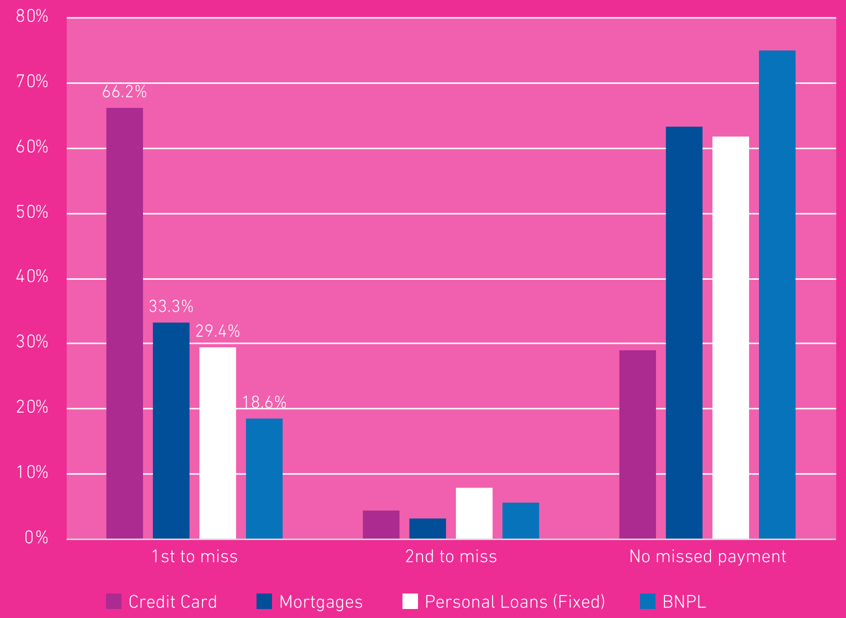
Deeper insights lead to deeper relationships

Only **16%** of Australian risk leaders surveyed were using enough data and sophisticated technology systems to identify red flags in the transaction data, and only **7%** had the capability to see a missed payment with other lenders.

These are concerning figures when you consider Australian consumers are increasingly turning to short-term lending to manage their finances in the face of the tough economic market. Experian saw a 54% increase in new credit card enquiries, a 42% rise for BNPL products and a 36% jump for personal loans in the last two years.

Analysis of missed repayments across credit products has shown that risk leaders have to know where to look for signs of credit stress. Looking at a subset of borrowers who have multiple credit products and no negative repayment history, two out of every three times (66%) that consumers missed their first repayment, did so on their credit card as opposed to one third of customers (33%) that missed a payment on their home loan first.

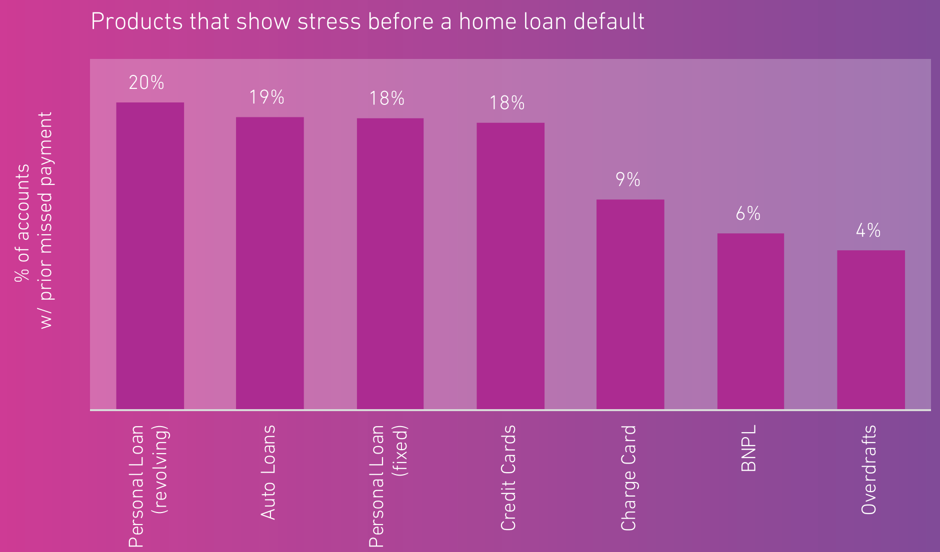
Progression of financial stress



Individuals in this sample had to have no negative Repayment History Information (RHI) between August 2019 and July 2021, negative RHI between August 2021 and July 2023, and more than one credit product type.

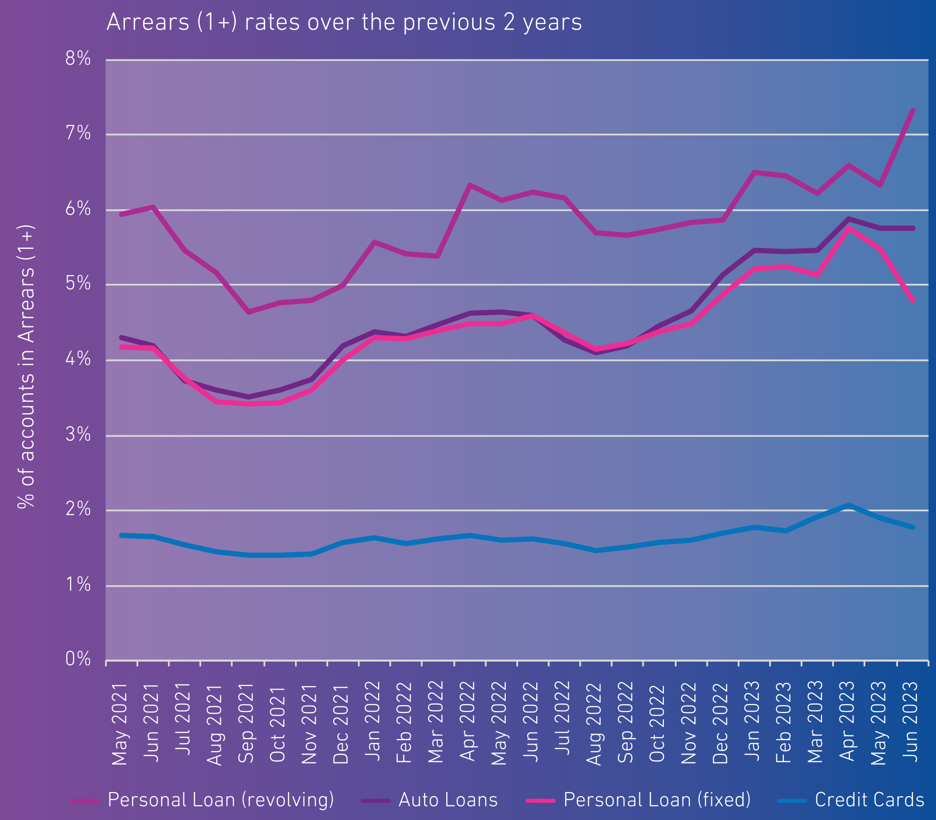
Potential lead indicators

The bureau data analysis also found that when a borrower defaults on multiple loans, they will likely start to miss repayments at different points in time across the different accounts they have. Looking at customers with products above 90 days past due, the analysis shows borrowers showed signs of stress across personal loans, auto loans and credit cards well before home loans. This highlights the importance of lenders actively monitoring customers across multiple products.



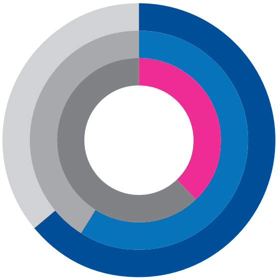
"The industry needs to shift to new data that is available from credit reporting bodies - repayment history data is a far better credit indicator."

– Credit risk leader, automotive finance



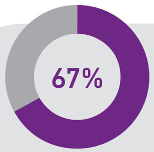
Greater investment is needed to navigate the challenging conditions

Most risk leaders in Australia said they need more resources and investment in technology and expertise if they are to stay ahead of the economic headwinds. 2 in 3 (**64%**) said limited resources and expertise was holding back their risk management systems from being the best they can be. Legacy systems that limited the speed, flexibility and accuracy of risk management was a major barrier for 3 in 5 (**59%**), while 2 in 5 (**38%**) said they needed a greater percentage of profits to be directed into risk technology and resources if they were to be successful.

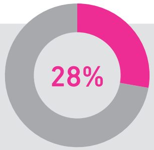


High quality bureau data helps lenders to gain a deeper understanding of an individual's credit commitments and financial circumstances, and how they may have changed. Lenders can see all financial products an individual has across different financial institutions and look at areas like missed repayments or increases in debt levels across multiple credit products. A person may look healthy in one portfolio, but look different in another.

Missing a payment for example is not the only way for lenders to identify whether someone may become more financially stressed and vulnerable. There are several triggers including a loss or drop in income, greater reliance on savings, a shift in spending to high priority items, and an appetite for high-cost loans for example.



Understand financial stress



Personalise collection strategies

Our UK business found that of the lenders surveyed that leverage Open Banking, **67%** were using it to understand financial stress and consumer vulnerabilities in onboarding or delinquency and **28%** were using it to personalise collection strategies.

Leveraging credit bureau data, Open Banking and triggers, combined with automated income and expense categorisation from transactional data for example can help lenders enhance monitoring and early warning systems to detect changes and spot customer vulnerability faster.

To be able to take large volumes of customers' specific circumstances, needs and preferences into account, lenders can leverage automated decisioning technologies that can create a single view of the customer in near real time. This opens the door for personalised contact strategies and support.

At Experian, data, analytics and technology are creating new opportunities for businesses to elevate their credit decisioning process. With award-winning solutions, such as Experian PowerCurve, Experian Ascend Analytical Sandbox and Experian Digital Affordability, we are helping businesses make fast and informed credit decisions.

"[The biggest influence on risk strategy in the last year has been] a greater awareness of weaknesses in various aspects and the resourcing of some of those areas as well as programs of work to address risk culture and place responsibility on the whole business in tackling risk. It is a slow journey, but the wheel will turn."

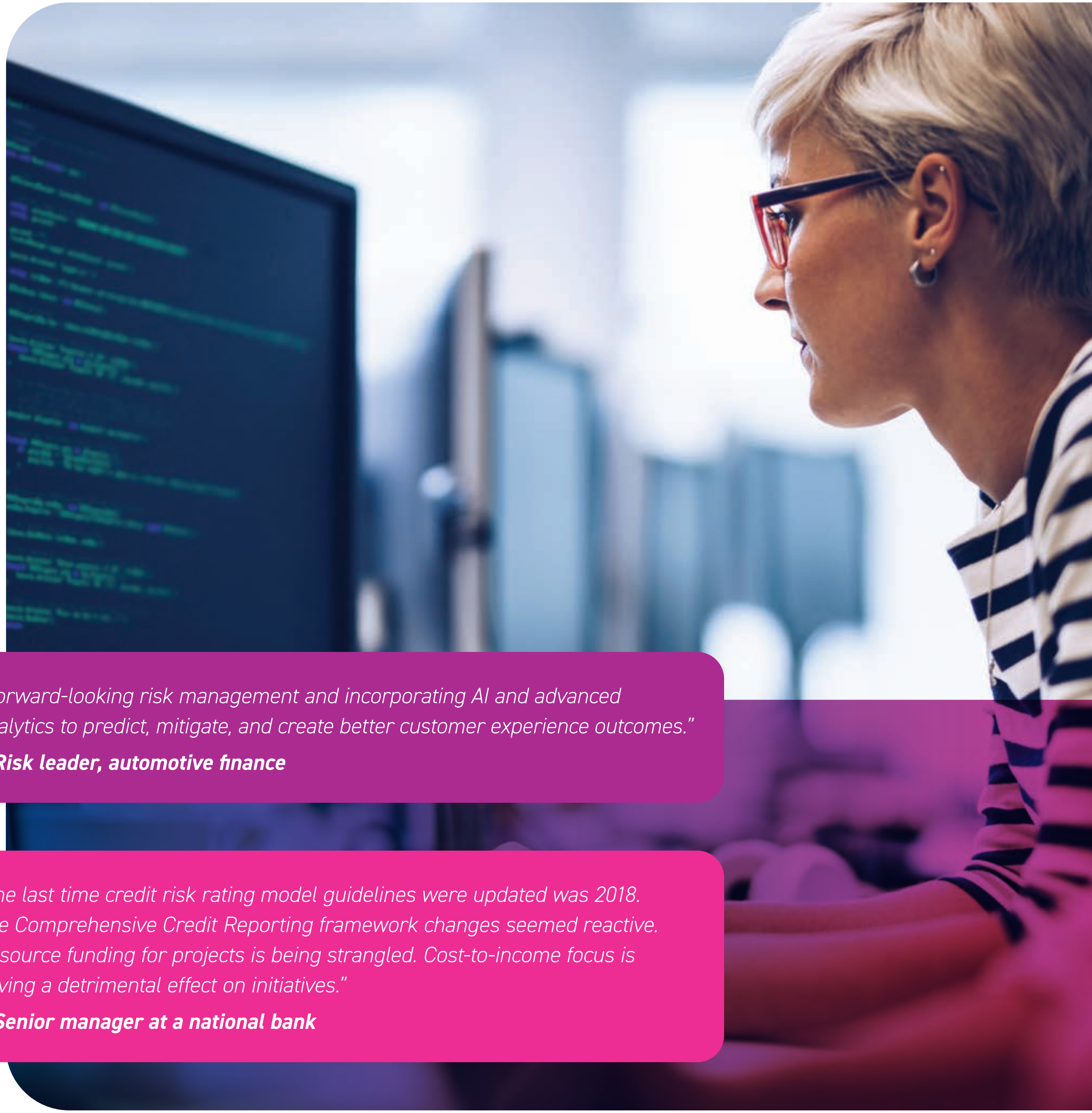
– Senior risk leader from a regional bank

Adopting AI in the credit decisioning process

Australian business leaders see cybersecurity (56%) and data privacy (52%) as the top risk constraints for the year ahead, followed by the impact of regulatory changes (43%) and macroeconomic risk (42%). Mitigating these risks depends on improving the predictiveness of models and unlocking value from a range of data sources. This is where artificial intelligence (AI), and particularly machine learning (ML), has enormous potential for Australian businesses.

Forrester research shows the majority (77%) of business leaders are prioritising investments in new data sources to better understand risk and affordability. It also found the biggest analytics-related challenge for nearly half of respondents (56%) is the ability to seamlessly connect different data assets in a data warehouse that can adequately support AI and ML use cases.

To address this issue, 80% are prioritising investments in cloud technology for seamless data integration with 61% agreeing that externally hosted cloud services are the best way to avoid data silos and aggregate data sources.



"Forward-looking risk management and incorporating AI and advanced analytics to predict, mitigate, and create better customer experience outcomes."

– Risk leader, automotive finance

"The last time credit risk rating model guidelines were updated was 2018. The Comprehensive Credit Reporting framework changes seemed reactive. Resource funding for projects is being strangled. Cost-to-income focus is having a detrimental effect on initiatives."

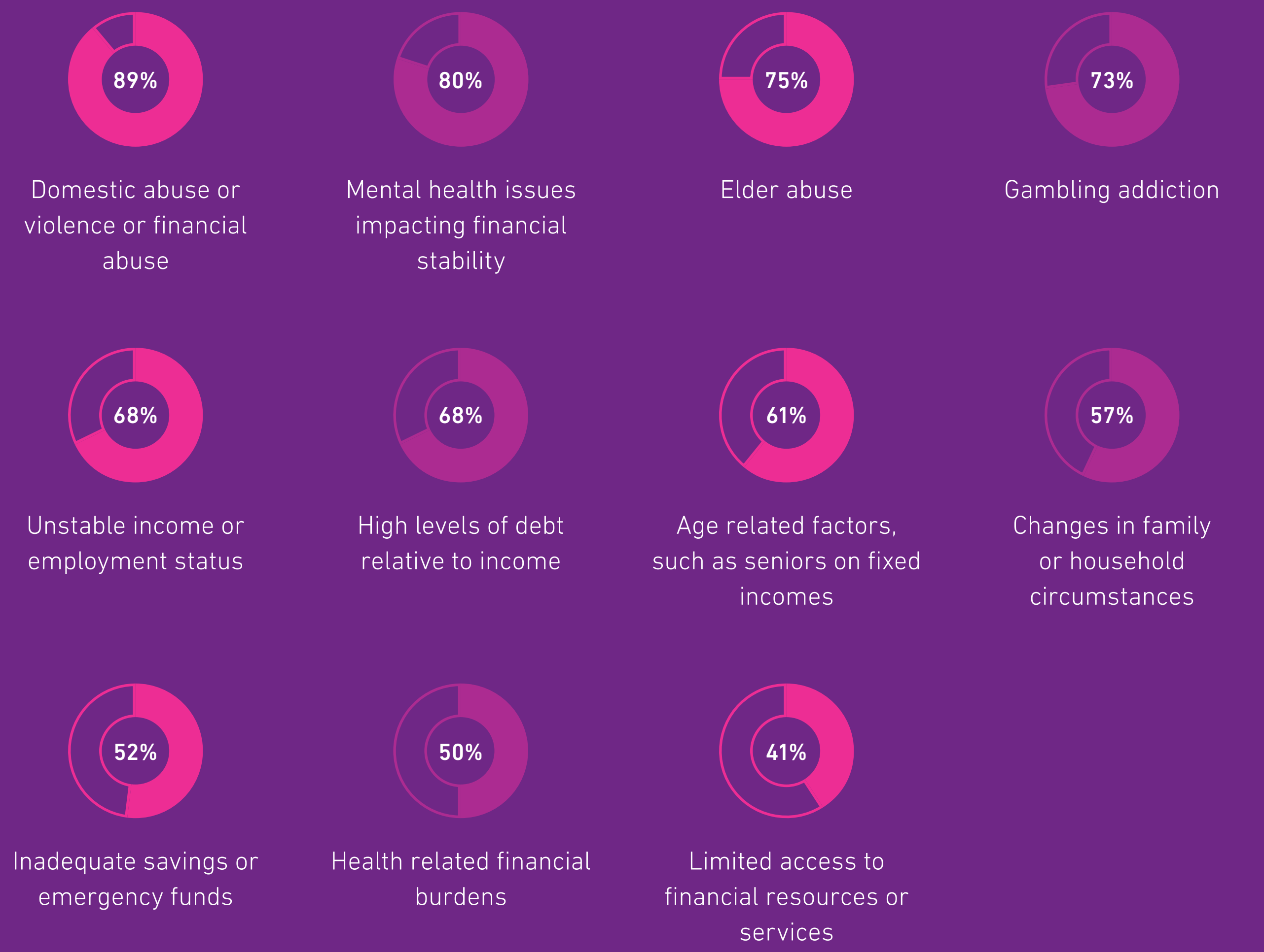
– Senior manager at a national bank

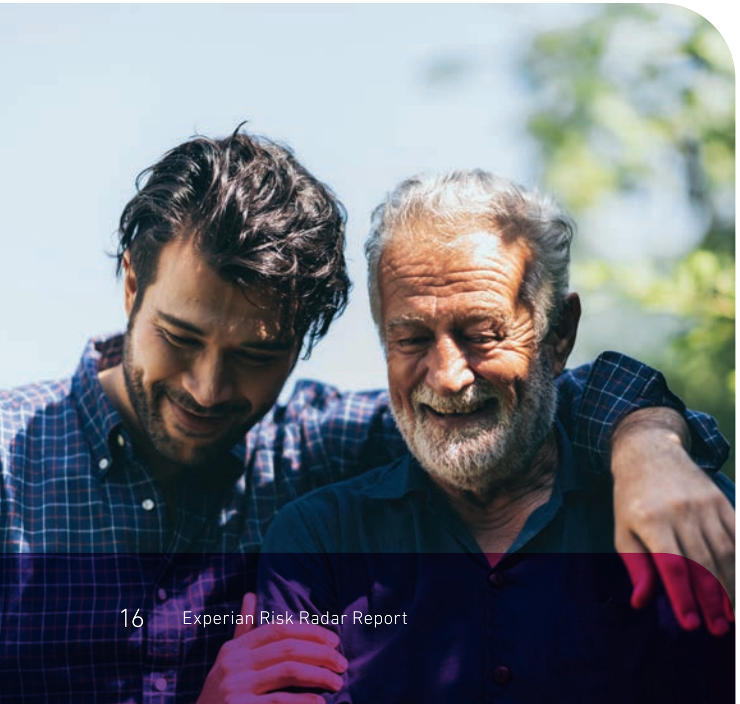
More to be done to address customer vulnerability

To protect potentially vulnerable consumers, organisations need to be able to spot them in their portfolios and get a full picture of their circumstances, in real-time so that they can support and transact with them in the best possible ways.

Almost half of lenders (45%) said they were somewhat proactive in addressing vulnerability, but there is room for improvement. 1 in 5 (20%) are proactive for multiple types of vulnerability and have clear procedures in place, while 16% are proactive for specific elements of vulnerability but recognise the need for improvement in other types. Almost 1 in 5 lenders said they currently have no proactive measures in place to address vulnerability.

Australian lenders are considering multiple factors to define customer vulnerability:





How the industry can change its approach to credit risk

Data quality and availability

Regulatory and compliance framework

Customer service and management

Alternative credit and debt solutions

Technological advancements and risk management

"Income and expense verification and validation – allows enhanced assessment of a customer's true financial position."

– Head of Operational Risk, Regulatory and Compliance, Taurus Motor Finance

Methodology

Experian Risk Radar research

Conducted in October 2023, this research engaged 75 Australian risk leaders, decision makers and influencers across financial services and telecommunications. The survey was distributed through Experian networks and through industry bodies Australian Retail Credit Association (ARCA) and Australian Finance Industry Association (AFIA) to their members.

Experian's 2023 Business Insight Report

In this research, Forrester Consulting conducted a survey of 889 business leaders in financial services and telecommunication across ten countries, including Australia, Denmark, Germany, India, Italy, New Zealand, the Netherlands, South Africa, Spain, and Turkey. This research was conducted in July 2023.

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Experian Australia Pty Ltd
Level 26, 2 Southbank Blvd
Southbank VIC 3006

T 03 8622 1600
E info@au.experian.com

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