Advice Matters

September 2016

Volume 3, Issue 9

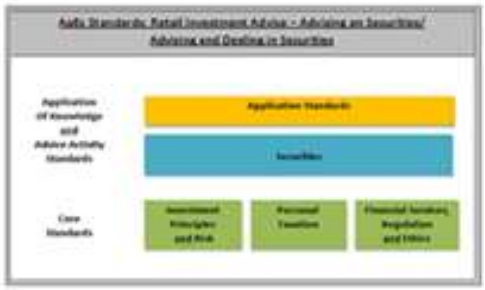
- One hour of structured CPD
- Industry update
- Key factors for your business
- Better interviews with your clients
- Technical know how

The CPD Solution For Financial Professionals

Inside this issue:

Welcome to the September Edition of Advice Matters

ApEx standards



The learning Outcomes and the ApEx Standards can be found at the end of this edition of Advice Matters

Welcome to the September edition of Advice Matters.

With the nights drawing in and the weather getting cooler, its time to think about what we can do to get ready for the last quarter of 2016, which often comes with a hefty price tag.

With this in mind, the first article looks at the consumer credit industry and whether we can identify those clients who may be facing or are already in financial distress.

Our second article focuses on IHT mitigation, in particular the lifetime gift allowances and exemptions. Do your clients make use of them and what are the consequences of them not doing so?

The last article compares and contrasts the main purpose and use of income protection and critical illness insurance, highlighting the confusion that exists for many consumers when it comes to including them in financial protection planning.

Our aim is to always cover issues and topics that you will find both useful and informative. If there is anything you would like us to include in future editions, please let us know. Your comments and feedback is important to us.

And in the words of John Keats, we hope you continue to enjoy the season of mists and mellow fruitfulness.

The Advice Matters Team at FSTP

Coming up next month, we will be looking at:

- Structured Products or Exchange Traded Funds – What would you choose?
- Inflation – Understanding, mitigation and how to get ahead
- Crowdfunding- the implications

Institute of Financial Services™
Recognised CPD programme

Staying On Track

This section will keep you up to date with the changes in Market, Product, Legislation and Regulation

Predicting which consumer credit users will suffer financial distress – is it possible?

People suffer financial distress when they face financial and non-financial difficulties from repaying their outstanding debts. Financial distress may mean filing for bankruptcy, increasing working hours, taking on additional jobs or reducing spending to meet credit repayments. By missing payments, or constantly struggling to maintain repayments at the expense of other financial commitments, an individual may also find that their credit record is impacted, reducing the ability to access further credit in the future. There may also be non-financial effects, such as stress or physical distress.

The figures below highlight the widespread use of consumer credit products within the UK:

- 61% of individuals hold a credit product
- 26% of individuals hold a credit product with outstanding debt
- The top 10% of individuals holding a credit product with outstanding debt have consumer credit debts worth over £10,300
- The top 10% of individuals holding a credit product with outstanding debt have consumer credit debts that are over 31% of their gross annual household income

However, none of the above statistics tell us that consumer credit is creating a problem for the individuals concerned.

The purpose of this article is to try and answer the question as to whether it is possible to predict which consumer credit users will suffer financial distress. In order to achieve this, we will consider four main areas:

- The debt to income ratio and what it can tell us
- The reasons why people borrow money
- Empathising more with the clients you may talk to

- The characteristics of individuals in financial distress

Understanding what the debt to income ratio (DTI) can tell us

In order to understand what the DTI can tell us, we need to understand what the DTI actually is, and the extent of the income or financial commitments included within it. Simply put, this ratio helps us to understand the value of the customer's debts relative to their income.

But what income and debt is (or should be) included?

Firstly, income can be either based on gross annual individual income, or gross annual household income – remember, many of your customers may have consumer credit agreements that have been taken on for the benefit of their family, it just so happens that the debt is in their sole name.

With regards to what debt to include, this is currently being debated– should just consumer credit figures be taken, or the wider financial commitments of the customer also be considered (such as household bills and more informal arrangements). The current standard measure is based solely on consumer credit agreements.

A recent FCA publication (Occasional Paper 20) stated that those with outstanding consumer credit debts hold, on average, an equivalent of 14% of their gross annual individual income, or 12% of their gross annual household income, of such debts.

Looking at the top 10% of individuals with consumer credit debts (and this group holds about a third of total debt balances), the average DTI amounts to some 38% of their gross annual individual income (or 31% of gross household income). Putting it another way, that's the same as 3.1 months of individual gross income required to cover their debts.

But what does that tell us? – well, basically, the lower the DTI, the more likely your customer will be able to cover any unexpected life events, such as redundancy or illness, and the less likely they are to suffer financial distress. So can we use this as a predictor of financial distress? The resounding answer to this is yes – recent research (FCA OP20) confirms that the most reliable predictor of customers falling into arrears is the level of total debt held as a percentage of their income (i.e. the DTI)

Why do people borrow money in the first place?

Borrowing money in itself is not necessarily a bad thing. During anyone's normal lifecycle it is expected that taking on a loan or credit card is accepted practice, particularly to cover certain events, such as purchasing a house or car. It is typical to find higher levels of borrowing amongst those who are starting out in life – setting up a home, or starting a family for example. At this stage in an individual's life, it would be expected that their ability to earn will continue for a long period of time, and maybe that income is rising, meaning the levels of debt can be serviced and finally repaid. As we know, usually during the later stages of life, borrowing tends to decrease, as major purchases, such as the home, have been completed. In addition, income levels tend to drop in retirement, curtailing the desire or ability to take on debt repayments.

So examples of common, usually acceptable reasons for borrowing are:

- To make a purchase – from something large, say a car or property, or something smaller like furniture or a computer
- Experiences – your client may have borrowed money (or want to borrow money) to spend it on experiences, maybe a large loan to travel the world, to a much smaller event, such as paying for a meal using a credit card

However, there are circumstances where borrowing is not an ideal solution, and may indicate an individual is experiencing some financial pressure, for example:

- Consolidating other loans – it is a popular (and sometimes encouraged) practice to borrow money to pay off other accounts or loans, so effectively consolidating other smaller debts into one larger loan, giving just one monthly payment. However, this can be a sign of a larger issue, such as being over extended financially and borrowing too much

- Living beyond our means – some people borrow money to live beyond their means. It can be anything from taking out a loan to make a lavish purchase of something not really needed, to using credit and credit cards to make up a shortfall in income each month. So the borrowing is taken out to bridge the gap between income and expenses, instead of looking at ways to reduce expenses.

The message here is that not all borrowing is bad, and in most cases, it is expected and accepted. However, you should take note of the potential warning signs indicated above, as ultimately financial distress may be the result.

Empathise more with the clients you talk to

Taking into consideration the reasons why people borrow money coupled with understanding the drivers and issues your clients face will build on your ability to identify some of the danger signs of financial distress. This can be achieved by talking to clients in a manner that encourages them to be honest with you as to their circumstances - empathy is the key.

Individuals who are struggling financially are sometimes reluctant to disclose their true situation. Embarrassment, pride, fear, feeling foolish, and anger – are just some of the emotions clients may experience. Responding and probing in a calm, empathetic manner should help you understand the true extent of their situation, thereby helping you to help them identify a potential solution or point them in the right direction.

Be more aware of the characteristics of individuals in financial distress

A very narrow, objective measure of financial distress is where clients are two or more payments behind:

- 2% of individuals holding a credit product with outstanding debt have missed two or more payments

This data is reasonably easy to monitor and record, however, missing payments isn't the only sign.

Data from Individuals self-reporting financial distress provides a much larger percentage:

- 17% of individuals holding a credit product with outstanding debt (or 7% of all individuals holding a consumer credit product) are in moderate to severe financial distress

The recent FCA research highlighted some common characteristics of people in financial distress, these being:

- Typically, younger
- With lower incomes
- Less likely to be employed
- Have higher than average debt to income ratios
- More likely to hold higher cost credit products (such as pay day loans)
- Likely to be less satisfied with life and more anxious than other borrowers

The above indicators are no surprise and not exhaustive. You may want to ask more questions when reviewing a client's circumstances and updating KYC especially if those indicators start to appear.

Early indication of clients who are more likely to suffer financial distress and helping those clients through bad times helps cement the relationship and they will remember when advice is needed in the 'good times.'

In conclusion

So can we predict which consumer credit users will suffer financial distress? It's not a 100% certainty but we can minimise the possibility by:

- Considering the customers DTI – the higher the figure, the more likely they will suffer financial distress, particularly if an unforeseen and unplanned for event occurs
- Clarifying why clients borrow money – credit for consolidating existing borrowings, or for managing on a day to day basis are warning flags
- Taking into account the common characteristics of those in financial distress – are any of your clients captured by those – if they are additional care may be needed to ensure they are treated fairly
- Talking to your customers with empathy – to gather as much information as possible to help you understand their situation.

Clients who are showing signs of financial distress are vulnerable - the regulator expects you to treat them as such.