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Rise of the alternative workforce:
How banks must respond

Unless banks take concerted action soon, the rise of the alternative workforce (i.e. non-permanent and non-salaried) could significantly reduce their operating profits and market share. Banks must use two innovation levers: product and pricing.

However, none of these innovation levers is immune to regulatory risks – in particular around customer fair treatment and vulnerability, as well as liquidity and credit risk management.

In this report, we set out what product and pricing innovation banks can pursue and how they can identify the associated regulatory risks.

This report is of particular relevance to banks': C-Suite, alongside strategy, product development and risk management specialists.

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Introduction

The traditional employer-employee relationship is being replaced by the emergence of an alternative workforce – temporary, on-call contract workers, freelancers, independent contractors and gig workers – that leaves no generation untouched. The alternative workforce is expected (according to governments and organisations such as the World Economic Forum) to increase dramatically over the coming years due to a combination of factors, including firms' cost pressures, technological adoption, and changing workplace cultures. In the UK, for example, the alternative workforce has increased to record highs to reach 15% of the employee base in 2017 (**ONS**, 2018). One survey suggests that the number of freelancers alone has increased by 43% between 2008 and 2016 (**IPSE**, 2017).

The alternative workforce differs from traditional employment in terms of both level and security of income and, consequently, access to some aspects of social security or insurance protections (**World Employment Confederation**, 2016). Whilst the alternative workforce is not new, novel developments are the scale it is reaching and its extension to all income levels. The greatest challenge the alternative workforce presents financial services firms with is income volatility. Many financial services firms – and in particular banks – have not evolved their products fast enough to keep pace with this trend. This challenge is exacerbated by the fact that Millennials – for whom the share of the labour force in alternative contractual relationships is the largest of all generations – will represent the highest segment of the global workforce in the next decade (**FT**, 2018).

We recognise that this challenge is by no means confined to banks; all financial services sectors have to respond to the alternative workforce. In this viewpoint, however, we examine only how banks should respond. That is, how banks need to innovate in terms of products and pricing strategy in order to meet the demands of the alternative workforce, factoring in the specific regulatory risks that follow. Most prominent amongst those risks are conduct risks, but there are also implications for credit risk and liquidity management.

If banks do not take further action by offering product and pricing innovation, the rise of the alternative workforce could significantly erode operating profits through its impact on demand for products, including the potential market share loss to new entrants, margin pressure, and eroding customer loyalty.

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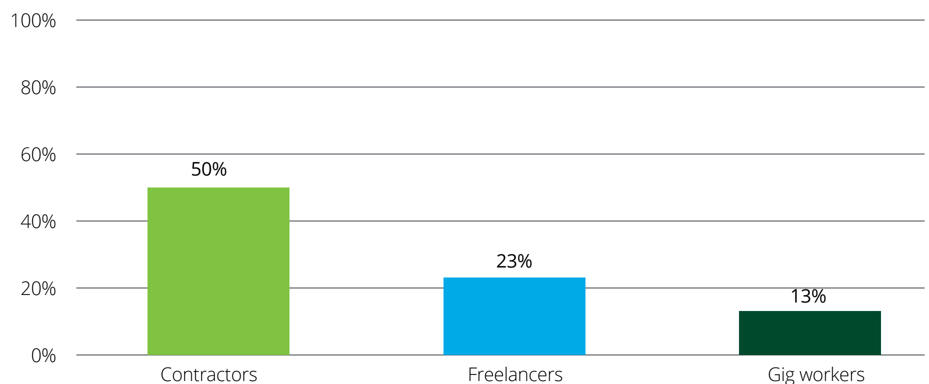
Trend – Rise of the alternative workforce

The composition of the workforce is changing dramatically. Research by Deloitte (**Deloitte**, 2018) found that only two fifths of survey respondents – across 11,070 business and HR leaders – reported that their organisations are primarily made up of salaried employees; and that employers expect to increase dramatically their dependence on contract, freelance and gig workers over the next few years (see Graph 1 (**Deloitte**, 2018).

Graph 1: Changing workforce

Respondents reported a significant number of...



Although segments of the alternative workforce differ, some general observations can be made about their characteristics. In terms of level and security of income, the alternative workforce earns, on average, less than its traditional full-time employed counterparts and has a more volatile income. In terms of protection, the alternative workforce benefits from less social security and employer provided protection such as life insurance, health insurance and pension schemes. In addition, it has less access to training, which can make it less resilient to changing market demands (and therefore more prone to unemployment).

These characteristics can make it challenging for alternative workforce customers to access traditional banking products, both because of how products are priced and risk assessed, and due to the fact that these products are often not particularly aligned to the alternative workforce's needs.

When the alternative workforce is segmented by level and security of income (**Institute for Employment Studies**, 2017), it becomes clear that the segments face variable levels of challenge in accessing traditional banking products **(see Figure 1**). A low level of income is of course an impediment to accessing traditional banking products as the customers concerned may have thin or impaired credit files, limited savings or unsustainable debt loads. Nevertheless, even those with a medium or higher level of income, when it is coupled with income volatility, also face significant challenges in accessing traditional banking products.

Segment	Income level	Income security	Challenge of accessing traditional banking products
1	Low pay	Unsecure	High
2		Secure	High
3	Mid pay	Unsecure	High
4		Secure	Medium
5	High pay	Unsecure	Medium
6		Secure	Low

Figure 1: Alternative workforce segmentation

The most frequent challenges that alternative workforce customers, across all income levels, face with banks include (IPA, 2018):

- a wide group – especially a majority at both ends of the income spectrum – struggled with income volatility as it leads to significant problems with paying bills and accessing financial services;
- 47% of mortgage applicants have found the experience of trying to get a mortgage fairly or very difficult (because banks' systems did not seem designed to deal with the alternative workforce customers, especially in terms of verifying income); and
- 53% of young people (aged 18-34) struggled to cover basic living expenses at least once a year.

Given the characteristics of the alternative workforce, product and pricing innovation is a necessity for banks, albeit that it may pose implications for the risk profile of banks. The product innovation, in particular, will also need to be supplemented with financial management tools, as the alternative workforce faces more complex financial management challenges than its salaried counterparts. More fundamentally, product innovation will need to offer ways of improving the alternative workforce's financial health.

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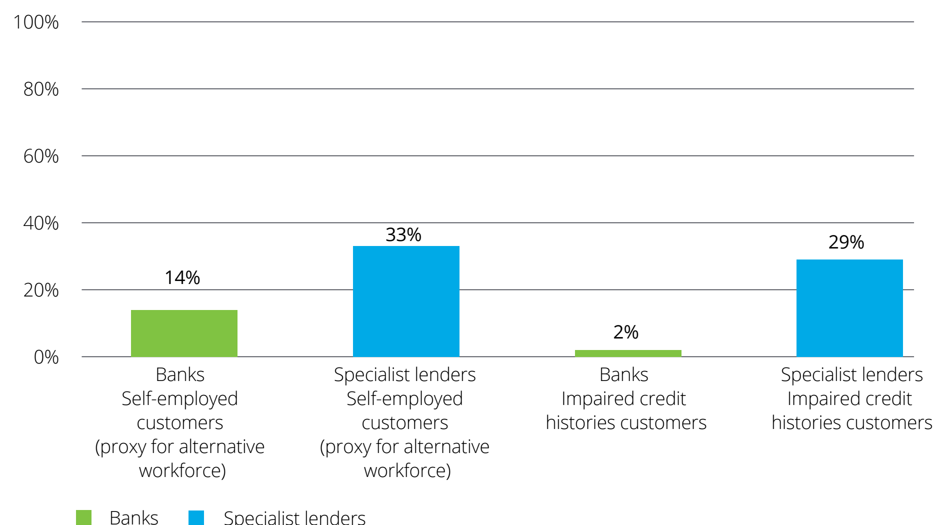
Implication – How banks must respond

Market response

There has always been some lending to specialists groups, but it has to date been a relatively niche area of lending and often subsumed within mass market lending books (see Graph 2 (**Bank of England**, 2018)).

Graph 2: Lending to alternative workforce



One reason conventional products are often not suitable for customers in the alternative workforce is that banks use both earnings histories and credit reports to assess the risk of lending. As many alternative workforce customers lack the traditional income statements required to create such credit reports, they find it difficult to qualify for loans because they do not meet the lending criteria. This issue is of course exacerbated where income volatility is high.

Some market players – banks, specialist lenders, FinTech, challenger banks and peer-to-peer (P2P) lenders – have started to respond to these challenges. Some banks in the UK are considering how to adjust their lending criteria (e.g., by, under certain conditions, considering applicants without a regular monthly income). Specialist lenders have also changed their lending criteria (e.g., waiving the need for years of bank accounts where a partner is employed) and have adjusted the cost of borrowing to reflect the income history of the applicant.

New entrants, principally FinTechs and challenger banks, have started to use their technological advantage (including data aggregation) to provide financial planning tools specifically designed for the alternative workforce (e.g. to bridge from volatile income streams to regular payments), and offer access to mortgages by partnering with mortgage brokers.

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Finally, P2P lenders enabled some borrowers with no or poor credit history to obtain a loan. The UK Peer to Peer Financial Association (P2PFA) reported that cumulative lending transacted through P2PFA member platforms exceeded £8 billion in Q4 2017, of which 52% were for individuals (**Crowdfund Insider**, 2018). However, the capacity of P2P lenders to serve alternative workforce customers with the appropriate products and apply adequate controls has been questioned. P2P lenders expect tighter regulatory scrutiny in future, which might slow the growth of lending.

To conclude, the challenge is how banks can serve the mass market in the future as it becomes increasingly based on the alternative workforce.

Profitability consequences

The long term profitability risks arising from these trends cannot be ignored by banks. By looking from a product perspective at the operating revenue and the competitive threat (from other market players – specialist lenders, FinTechs, challenger banks and P2P lenders – targeting the alternative workforce), the products that are most at risk for banks can be identified[1] .

The level of competitive threat is often driven by the entry barriers (e.g., costs, regulatory licences and authorisations, capital requirements) that other market players are facing for different products.

In Figure 2, products are positioned according to the relative risk posed for revenue. The products most at risk are payments and deposits. The products facing a medium risk for banks are personal loans, overdrafts and credit cards and mortgage lending.

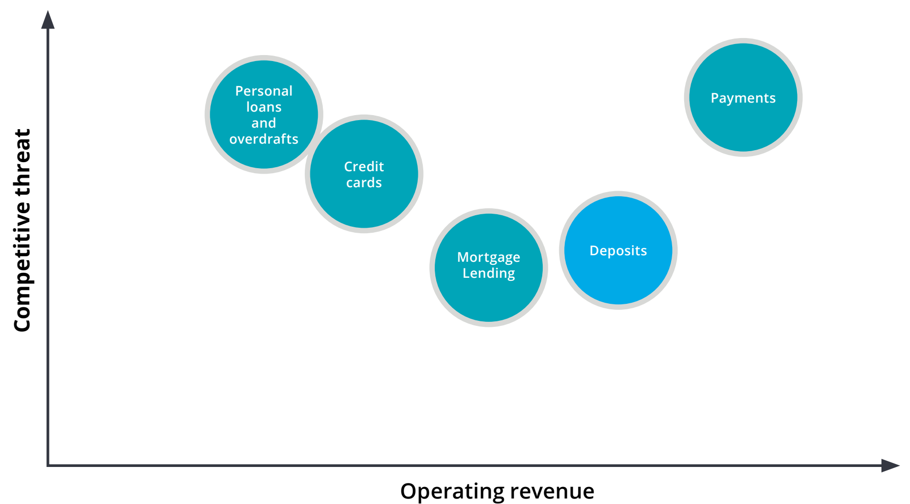

Figure 2: Banks' products at risk

Innovation imperative and regulatory risks

In pulling the twin levers of product innovation (i.e. credit and savings products) and pricing innovation (i.e. usage-based pricing), a key challenge for banks will be to anticipate the regulatory risks that may arise.

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[1] The revenue is assessed by looking at banks' break-down of revenue per product. The competitive threat is assessed by looking at the market share trend per product of other market players.

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In terms of credit products, innovation will likely involve adapting behavioural credit scoring approaches to take into account the different behaviours of a customer segment that has less predictable income flows. Where customers have a lower credit score or behavioural score due to variability in income, then market players may have to utilise manual underwriting processes, rather than relying on scorecards and decision making algorithms. As part of this adaptation in behavioural credit scoring, banks will need to develop approaches that recognise and allow for income volatility as well as determining affordability criteria that allow credit products to be offered.

Where banks have existing Internal Ratings Based (IRB) models that permit the use of own estimates for calculating credit risk capital requirements, they may face capital add-ons or even a requirement to use Standardised risk weights for these customers until such time as they are able to satisfy modelling requirements for the new customer segment. Whilst the imposition of capital add-ons or the use of Standardised risk weights will push up capital requirements, this does not necessarily mean that banks would have to raise new capital but rather reallocate the existing stock. In addition, the initial barriers for using IRB modelling will reduce as the volume of data for the alternative workforce segments grows over time. The extent to which this flows into increased pricing for customers remains to be seen, particularly given potential conduct issues that may arise from differentially pricing to this segment.

Such credit product innovation would entail one key conduct risk, namely customer vulnerability. This topic has come under particular scrutiny recently from the UK FCA. This customer vulnerability risk arises throughout the different stages of the product lifecycle (see Figure 3).

To mitigate against this, for each stage of the product lifecycle, a number of actions that banks must take can be identified as follows.

Product lifecycle stage	Customer vulnerability mitigation actions
1. Strategic considerations	• Assess desirability to provide products for the alternative workforce segments whilst avoiding financial exclusion • Identify, through management information (MI), less financially sophisticated consumers without inferring that the alternative workforce segments (1, 2 and 3 in particular (see Figure 1)) are less financially sophisticated • Offer product flexibility according to the needs of the alternative workforce • Re-assess AML requirements and their application for the alternative workforce segments

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2. Product design	• Identify product features that are relevant to the characteristics of the alternative workforce segments • Offer a single customer view (e.g., invest in data analytics and in clean IT systems) to facilitate more accurate credit risk analysis and to inform all customer decision-making • Build product features that allow customers to have enough flexibility to exit them • Provide greater flexibility over how overdrafts are used (e.g., by setting less stringent repayment deadlines) as the alternative workforce segments (1, 2 and 3 in particular (see Figure 1)) have a greater propensity to use overdraft facilities • Embed educational features in product (through questions and helping points)
3. Product marketing	• Map and disclose clearly risks associated with products • Embed transparent disclosures in product • Embed nudges and nuggets to break down the financial decision-making process into smaller steps, as part of digital marketing
4. Product delivery	• Widen affordability assessment (e.g., bring guarantors or third party to agreement) • Offer credit building products (i.e. start with lower credit level and allow it to build up over time)
5. Origination	• Assess qualification of the alternative workforce customers to obtain product (by leveraging multiple data sources and proxies (e.g., such as credit reference agencies and scores, history of rental payments, etc.)) • Demonstrate pricing fairness
6. Product use and duration	• Demonstrate safeguards around alternative workforce customers • Embed early warning systems • Offer personal financial management apps
7. Termination	• Allow more forbearance in the future (i.e. to avoid negative mark on credit file)

Figure 3: Conduct risk mitigation in product lifecycle

For savings products, and deposits in particular, banks will need to offer customers more convenient ways to deposit and manage their money. Further, banks will need to develop financial management tools appropriate to the situation of the alternative workforce and embed these as product features in money management tools and platforms. These tools might include spending controls (including nudges) on remaining disposable income and debt consolidation. A debt consolidation feature can shift the balance of capital and interest repayment more towards paying down the debt so that over time debt reduces and customers become more creditworthy.

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Even if banks offer customers more convenient ways to deposit and manage money, a prudential liquidity risk could arise due to greater deposit volatility – a consequence of the income volatility of the alternative workforce. Deposits are a key source of funding and liquidity for banks, and banks rely on the fact that a large proportion of deposits is typically stable. This assumption is reflected in the calibration of a key regulatory metric, the Liquidity Coverage Ratio. The deposit behaviour of customers in the alternative workforce may challenge this assumption with implications for how banks manage liquidity. To mitigate this, banks will need to review their liquidity management, including their outflow assumptions as part of their liquidity stress-test. This change in the dynamics of deposits aligns to a more significant trend driven by the introduction of Open Banking.

Moving beyond product innovation, pricing innovation, is also a key tool for banks in meeting the needs of the alternative workforce. That is, as products evolve, so must pricing. As seen previously, due to the characteristics of the alternative workforce, it may lack either the capacity or the appetite for paying on a cost-plus basis, as it usually applied (i.e. the seller calculates all fixed and variable costs and then applies a mark-up percentage to these costs to estimate the asking price for products).

As such, pricing innovation can be a tool for competitive differentiation and to raise profitability (**Deloitte**, 2016). Traditionally, banks have used cost-plus pricing. No other pricing method is easier to justify, as it is inherently fair and non-discriminatory. However, one of its drawbacks is that it ignores the customers' capacity and appetite to pay and competitors' prices, which is key for the alternative workforce.

Banks could apply usage-based pricing (i.e. a form of price discrimination reflecting differences in customers' usage of the product resulting in different mark-ups for different consumers) in addition to cost-plus pricing. The key advantage of usage-based pricing is to allow banks to fine-tune their pricing per product as opposed to across products. In addition, once the demand is understood (through product usage profiles of customers), banks can use bundling to increase cross-selling. One key advantage of usage-based pricing is that it offers banks financial predictability – which is important given the characteristics of the alternative workforce – and enhanced customer relationships.

Pricing innovation, like product innovation, is not immune from conduct risks, in particular in terms of customer vulnerability and potentially harmful cross-subsidies. Pricing innovation in banking has attracted, and continues to attract, regulatory scrutiny – due to concerns around fairness of certain pricing practices. To mitigate against customer vulnerability, banks will need to ensure that price differences between product variations are justifiable and that behavioural pricing does not lead to unacceptable price discrimination against the alternative workforce.

To mitigate potentially harmful cross-subsidies (that raise distributional concerns), banks will need to provide a strong rationale backed up by evidence (e.g., MI). Such evidence must be based on outward-looking measures that assess potential harm or the outcomes produced by the bank's pricing innovation. This evidence must show that the cross-subsidies are: (i) temporary and used for banks to get to a break-even point; (ii) encouraging the launch of innovative products and so help foster competition and market access; and/or (iii) benefiting a customer segment with a lower/volatile income.

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If banks do not take further action, the rise of the alternative workforce could significantly reduce their operating profits and market share. Banks must therefore use two innovation levers: product and pricing. Neither of these innovation levers is, however, immune from regulatory risks.

Banks – and of course the regulators themselves – will need to consider potential tensions between prudential and conduct requirements and objectives. Since the establishment of "twin-peaks" supervision, co-ordination between the FCA and PRA has been, rightly, an operational imperative for both institutions. As the rise of the alternative workforce becomes a major structural change in society, the FCA and PRA will need to collaborate closely on their approach to the regulation of banks that are adapting their business models and lending procedures towards catering for its borrowing and savings needs.

In doing so, both regulators will need to consider how, consistent with their objectives and the maintenance of appropriate regulatory standards, they can respond supportively to banks that are pursuing the necessary product and pricing innovation. One possibility would be to expand the perimeter of the FCA's "Regulatory Sandbox", and the boundaries of the PRA's challenger bank strategy, to include established banks' testing of new products and pricing strategies for the alternative workforce in controlled "live" situations.

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