Credit Risk Market Update

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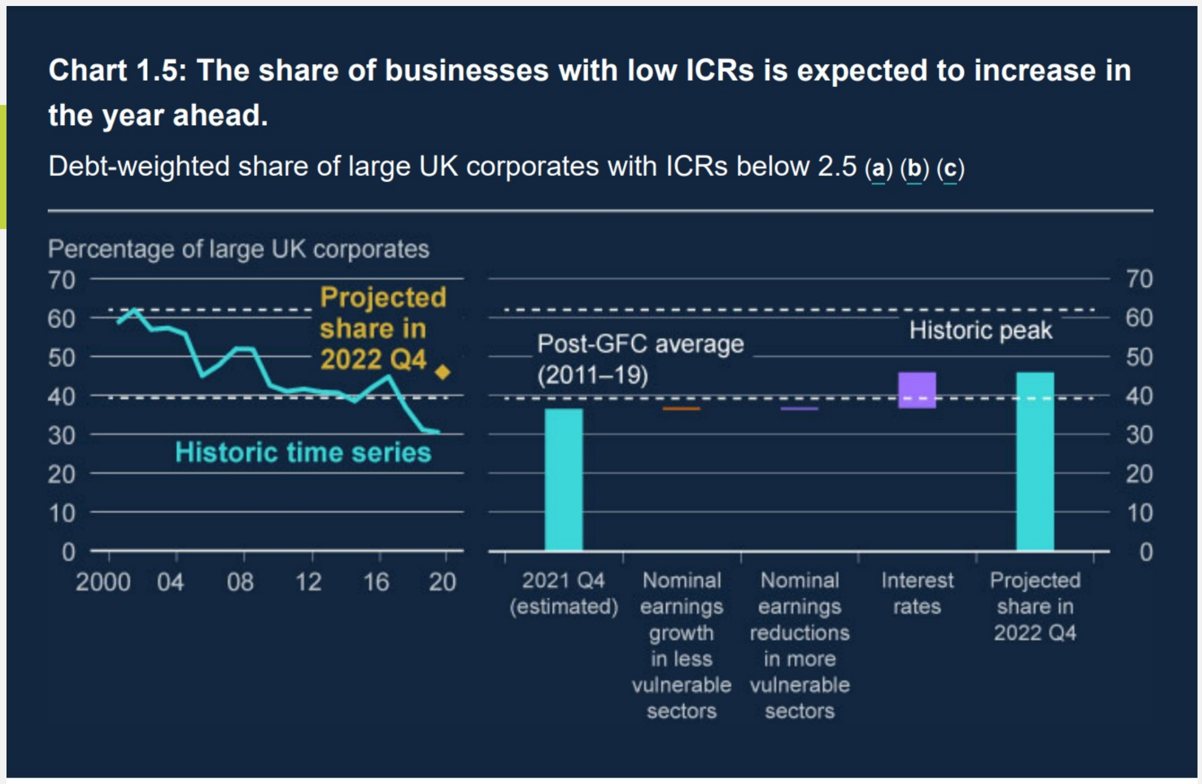
12%

Economics

The rate of inflation is set to exceed 12% in November and remain high through the first half of next year. How well are households placed to deal with such a shock?

At the moment, surveys show few signs that more people are struggling to pay their housing and energy costs. Recent figures from the Citizens Advice Bureau suggest if anything, that overall levels of inquiries about debt advice are lower than what we might consider normal. But there are signs of stress among those on low incomes that use prepayment meters and for many, this is the calm before the storm. Latest estimates show the energy price cap rising from the current £1,971 to £3,500 (78%) in October and then a further (10%) to £3,850 in January. The true picture will only emerge when colder weather arrives.

In July the Bank of England painted a relatively reassuring picture where the increase in living costs was largely offset by government support: this meant the numbers of customers with high debt service costs was flat over 2022. But the latest projection of the cap means that analysis already looks dated. The next Prime Minister will be under pressure to provide more targeted support to poorer households. Yet that has hardly been mentioned in the election campaign.



Sources: Bureau van Dijk, S&P Capital IQ and Bank calculations.

Firms have received no help, and their plight little discussion. The crisis could be existential for many who are intensive users of energy come winter. When higher interest rates are added in, there will be a significant rise in the proportion of firms with low interest coverage ratios according to the Bank of England.

While this refers to large companies, smaller firms in hospitality and manufacturing also look exposed. In terms of credit risk implications of the crisis, the corporate sector is still where concerns are greatest.

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SME Collections and Recoveries

Firms with an SME customer base will have recently received a 'Dear Chair' letter from Sheldon Mills, Executive Director FCA. The FCA have completed a multi-firm review assessing how retail banks treat their SME customers in Collections and Recoveries.

The review highlighted six areas of concern that the FCA believe may be driving poor customer outcomes. A few of these areas should be straightforward to remediate notably gaps in policies and procedures and inadequate staff training, including ensuring that staff are able to recognise characteristics of vulnerability and act on them appropriately.

Three of the areas in the letter which may require some significant resources are:

1. Removing manual interventions within systems, in particular where these relate to the identification and treatment of vulnerable customers;
2. Enhancing record keeping practices and systems to ensure that accurate 'customer files' are readily available; and,
3. Completing outcome testing and quality assurance to assess whether SME customers are receiving fair outcomes.

Focusing on the third of these areas, the FCA would like to see that firms are actively improving their policies and procedures considering feedback from this outcome testing and quality assurance. They have raised this requirement for regulated lending within their finalised guidance on the new Consumer Duty, detailing that firms must 'assess whether the outcomes that their customers are experiencing are consistent with their obligations under the Duty.' As this will likely be a notable change it is important to ensure that any MI from testing and quality assurance is set up in the right way to ensure that firms yield as much benefit as possible from the new data, whilst fulfilling their duty to their customers and the FCA.

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Model Risk Management Principles

Further to our insights update: Model risk and the development of appropriate frameworks arising from Covid-19, where we highlighted model risk challenges during the pandemic, in response to the increasing complexity, breadth and use of models. The PRA have issued a consultation paper 6/22 (CP 6/22) which sets out how the supervision of this risk will be broadened and strengthened.

The scope of model supervision is proposed to be broadened so models used for fraud risk, anti-money laundering, and those used for accounting, for example, will be put under the scope of the framework.

The framework will be underpinned by five principles:

- **Model identification and model risk classification** – Setting the scope for Model Risk Management (MRM) with an associated inventory of models with risk-based tiering.
- **Governance** – A strong MRM culture promoted from the top with the board approving MRM policy , appetite and appointing an accountable SMF individual.
- **Model development, implementation, and use –** Robust development, and testing and monitoring standards for all stages of the model lifecycle.
- **Independent model validation –** A validation and remediation process with ongoing and independent challenge to the use and development of models.
- **Model risk mitigants –** Established policies and procedures for the independent review of post model adjustments.

Whilst there will be a proportionate approach to all 'simpler-regime firms' (see CP 5/22) all firms will have been expected to do an initial review and produce remediation plans within one year following the issuance of the final supervisory statement on model risk.

All banking firms will already have MRM to varying degrees, however the challenge with implementing the new regulation could well be setting policies and standards that are consistent across different functions in the business (operations, finance, treasury and risk for example) where previously they have been owned within functions. Creating a plan and approach now (and earmarking resource and any organisation changes) for regulation that will likely land next year will create the foundations for an efficient and effective response.