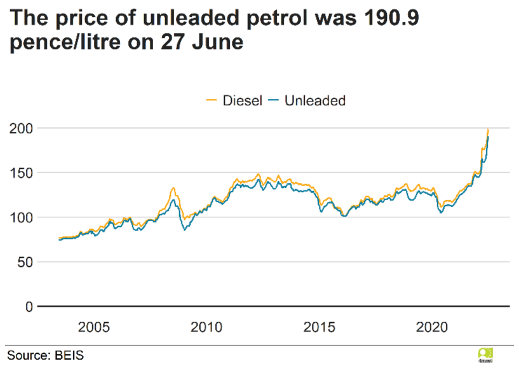
4most Credit Risk Market Update

Keeping you up-to-date with our latest expert insights

July 2022

Economics Update

Inflation rose to 9.1% in May. Since then, petrol prices have risen sharply and Russia's war in Ukraine could well push food prices up much further in the coming months. With this pressure, and another hefty rise in energy price cap, the Bank of England expects a peak of 11% in inflation in October.



How much will interest rates rise? The Bank's last forecasts in May suggested a bank rate of 1% would eventually bring inflation back to target. But the increase in June indicates a desire to get inflation back to 2% sooner than 2025. The best interpretation of the Bank's message is that rises will be gradual and modest. The case for a 50bp rise will probably not be any more persuasive than it was in June.

There is a big discrepancy between what the Bank is signalling and what markets expect, as captured in the Overnight Index Swap rate futures curve. Here an increase to over 3% is priced in. The difference is important and of course is already having a big impact on pricing. At some stage either the Bank or markets will be proved wrong.

The expected path of interest rates is suddenly more important for calculating affordability of mortgages than it was. The timing of the Bank of England's decision to remove the requirement to add a 3%-point affordability stress to mortgage reversion rates is interesting to say the least.

The MCOB rules in the FCA handbook means banks still need to apply at least a 1%-point stress. But with markets expecting a rise in interest rates to 3.25% from the current 1.25%, a stress of 200bp would seem appropriate, even if most commentators do not expect such a steep rise. Given this, the impact of the change of rule will be muted at the moment.

But go back a year and the conclusion would have been very different. Markets did not expect rates to reach 1% over the forecast horizon. A 100bp stress would have seemed appropriate. But with hindsight and rates at 1.25% and rising, that would have underplayed what has happened. Most of that lending last was on a fixed rate. But the payment shock is delayed rather than avoided.

The Bank of England will point to its research showing that its rules on high loan-to-income lending are adequate in dealing with this prudential risk. But it does feel uncomfortable that situations can so easily arise where the stress applied is lower than that subsequently seen.

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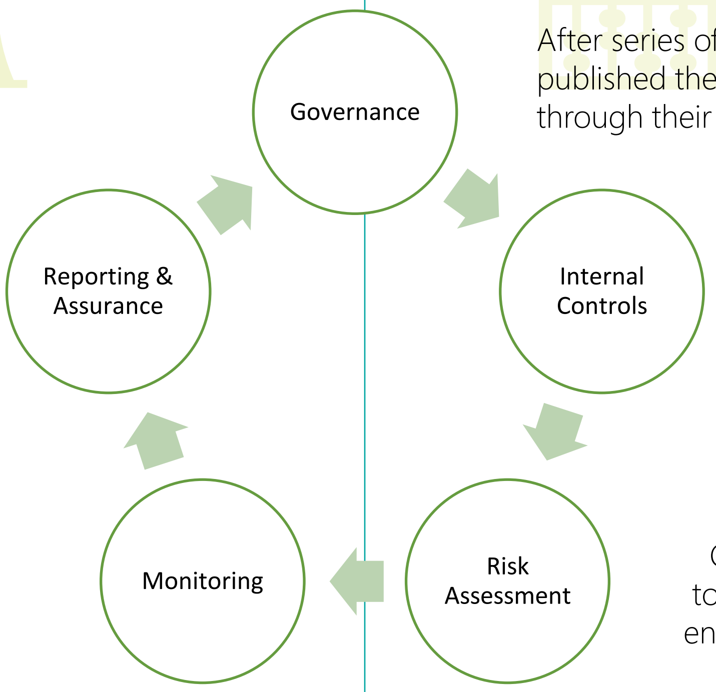
New principles for Risk Management

BCBS: Climate-related financial risk

Last month, BCBS published a set of principles for the effective management and supervision of climate-related financial risks.

The principles cover a range of areas, from corporate governance and internal controls to risk assessment, management and reporting of climate risks. They provide financial institutions and supervisors with guidance on developing capabilities and expertise in this new risk management discipline in order to address the physical and transition risks from climate change that could affect the financial system.

The principles are expected to be implemented as soon as possible, and are intended to be applied on a proportionate basis depending on the size, complexity and risk profile of the bank.



PRA: Model Risk Management

After series of calls for improved model risk governance the PRA have published their proposed SS on Model Risk Management (MRM) Principles through their consultation paper CP6/22.

The PRA have proposed 5 high-level principles, covering the model lifecycle, and are encouraging firms to treat MRM as its own risk discipline, along with its own accountable SMF. Firms will have to perform a self-assessment against these principles, and their sub-principles, and monitor their progress towards closing out gaps.

Of the five principles, it may be the requirements set out in the Governance principle that will lead to the most effort and change to current processes. In particular as a result of the requirements for enhanced model risk reporting to the Board. .

Fortunately, 'Simpler-regime firms' can avoid the most onerous of these requirements, with reduced Governance expectations and limiting the scope of the Development, Validation and Mitigation principles to those models identified as having a material bearing on business decisions, and where these models are complex in nature

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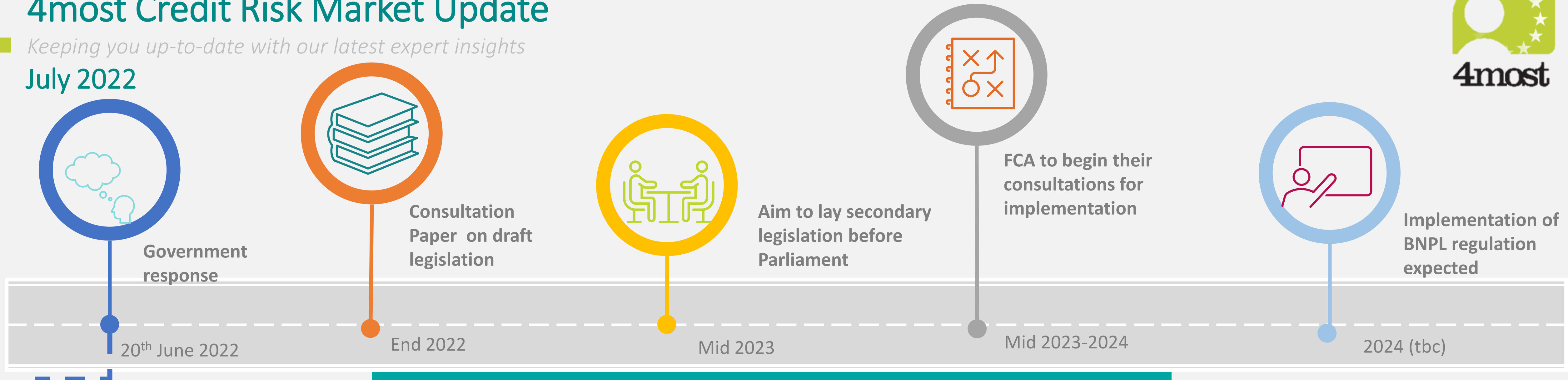

Buy Now Pay Later Scheme (BNPL) – Regulation Roadmap

In response on the initial consultation of BNPL regulation, the Government has confirmed several key points:

- BNPL will be brought into the regulatory regime, becoming subject to the FCA's rules on financial promotions, creditworthiness assessments (including affordability), and treatment of customers in arrears
- There will be a requirement for pre-contract disclosures, however these will be less onerous than those currently required under the Consumer Credit Act
- BNPL contract requirements will be prescribed under legislation, and rules around improper execution will therefore apply.
- Section 75 CCA protections will be extended to BNPL agreements, allowing consumers the same protections afforded to purchases under credit cards, point-of-sale finance and similar forms of credit
- Lenders will be brought into the jurisdiction of the Financial Ombudsman Service (FOS), allowing customers of BNPL to take complaints to the FOS

The position of the Government to draw a distinction between BNPL and short-term interest free credit (STIFC) has changed following a blurring of product features such as BNPL moving to include higher value transactions and STIFC moving increasingly online from in-store.

- Expected that non-merchant STIFC will be included in the legislation
- A grey area currently exists around merchant-provided STIFC, with the Government minded to include this also in the regulation if it is offered online or at a distance
- There are also a number of exemptions designed to ensure that other forms of currently exempt credit, such as invoicing, employer/employee lending, financing insurance contracts and similar are not inadvertently dragged into scope, and that regulated providers currently using CCA compliant pre-contract and contract forms for exempt STIFC will not be disadvantaged.

A further consultation (running until 1st August 2022) is taking place on this with a final decision to be made public when draft legislation is published around the end of 2022.

If you need any support with any of the topics listed, please get in touch.
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