# 4most Credit Risk Market Update

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March 2022

## Impact of cost of living crises on the UK economy

The unfolding situation in Ukraine is fundamentally a crisis that will be remembered in terms of the needless loss of lives. The economic sanctions put in place against Russia will cripple that economy as well as deepen and extend the cost-of-living crisis in Western economies.

**Inflation is set to peak at 8% as energy prices continue to rise**

In the UK, inflation is set to peak above 8% as petrol prices reflect the spike in the cost of crude oil. And unless wholesale gas prices ease, another big rise in energy bills is on the cards in October. The inflation rate is likely to be still above 6% at the end of the year.

**Rising inflation could result in unprecedented fall in real household incomes**

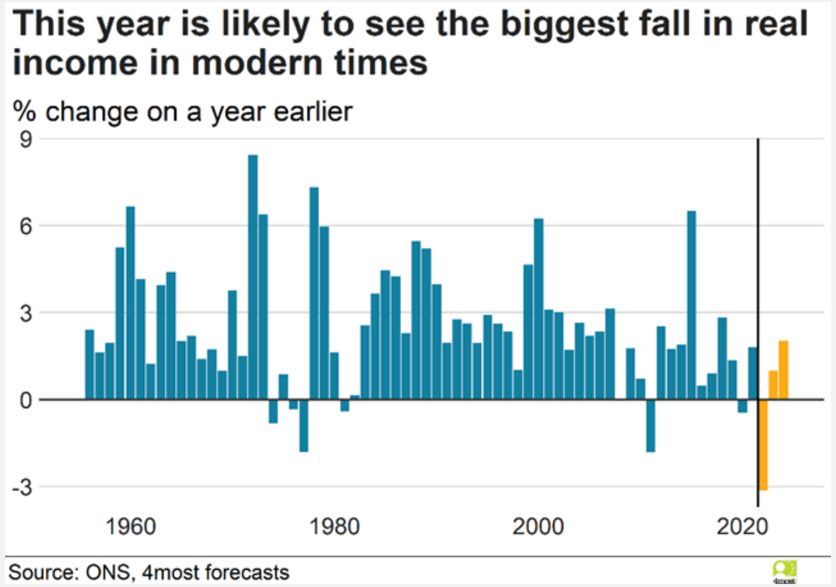
Worryingly, household real income could fall around 3% in 2022, an unprecedented contraction in modern times. The last big squeeze was in 2011 when real income fell 1.8%.

**The number of people registering for "breathing space" from creditors rose sharply in January. And the huge rise in energy bills in April will only bring more stress to these households**

The households that built up savings during the pandemic might be insulated from the impacts of the rising cost of living. But the big concern is centred on households at the bottom of the income scale. These households spend a larger proportion of their income on energy and could see a drop in real income of around 6%.

**It is hard to quantify the credit risk implications of such an unprecedented economic event**

In terms of credit risk analysis, it is hard to model the impact of an unprecedented event. Ideally banks will have an assessment of customer affordability, which gives an estimate of the buffer borrowers have in this situation. Elsewhere models that use nominal income can be used to try to calibrate 'Post Model Adjustments'.



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## COVID Data: Impacts on Credit Risk Modelling

### Model Development

The key issue is how to approach the crisis caused by Covid-19 that does not lead to "standard" signs of a recession, such as the unexpected breakdown of observed default rates of customers with the Macroeconomic environment.

Currently, the commonly adopted practice within the industry is to remove the uncertainty of Covid-19 within their models, given that periods before Covid-19 are expected to be more representative of a general response to Macroeconomics. This may resolve this issue for current developments, but in the future the next hurdle will be how to address Covid-19 impacted periods for modelling when these periods may be more representative of the current population.

### Monitoring, Reporting and Calibration

This challenge relates to ongoing discussion of how to incorporate Covid-19 data within Monitoring, Reporting and Calibration. In other words, how to move away from commentary regarding the fact that it is 'due to covid'?

Although its still in its infancy, there are ongoing discussions of how to treat Covid-19 impacted data. This includes methods such as reallocating delayed defaults or the creation of defaults through a softer default definition for key indicators that may not be considered as a default outside of the exceptional circumstances. This data treatment may be a solution for future developments, whether for construction of models or to validate performance.

### Mortgage IRB models – Potential Hybrid PD Solutions

Mortgage IRB model remediation is well underway across organisations with PRA feedback sessions being held throughout Q1. 4most has been heavily engaged in this activity across a number of organisations including the coordination of a questionnaire benchmark activity in Dec 21 across 5 current UK mortgage IRB lenders.

The task of developing a compliant solution considering cyclicality, discrimination and RWA impact is proving to be challenging but progress is being made as different options are explored. This is also proving troublesome for aspiring IRB organisations who have incumbent hybrid methodologies in parallel run but are aware that updates will be required prior to submission and approval of their module 2 application component.

## Buy Now Pay Later Scheme

It's clear that BNPL fills a gap in the market, evidenced by its rapid expansion in recent times. However, its existence outside the regulatory perimeter poses risks, principally around creditworthiness and visibility.

BNPL firms are not required to follow FCA creditworthiness practices increasing the possibility of poor consumer outcomes; For example, taking on more debt than is affordable (a concern raised by many BNPL users). Whilst one might assume that a firm's commercial interest would drive it to only take on customers that could repay, this blurs credit risk, concerned with the risk to the firm, with creditworthiness, which focusses on the risk to the consumer.

Both risk to firms and consumers can align but it's not a given, it's possible, intentionally or otherwise, to construct a business model with profitable lending but also a high percentage of poor outcomes – many payday lenders had models of this type. Robust creditworthiness assessments alongside strong credit risk controls would protect consumers' and firms' interests.

Lack of visibility of lending and its possible consequences is also an issue for customers - the FCA has just reported finding potentially unfair/unclear terms in contracts from a group of the largest providers of BNPL in the UK, highlighting terms explaining late payment fees were not sufficiently clear.

From a customer perspective

Customer borrowing from BNPL is yet to be fully captured in credit bureau datasets and so is not visible (although CRAs have recently announced positive moves in this direction). Without a full picture of debts and expenditure, there is greater potential for harm to the customer and lender.

From a lender perspective

These are examples of what can happen when consumers' interests aren't fully considered. Placing these firmly at the heart of all firms is the key goal of the Consumer Duty – it is clear that BNPL should also be required to follow this.