4most Credit Risk Market Update

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

November 2021

Inflation is set to peak at around 5% regardless of interest rate changes

Bank of England held off raising rates in November but shocks due to supply side constraints can lead them to reconsider.

While Bank of England held off raising rates in November, it indicated that rate rises will be necessary over the coming months to contain inflation. The markets expect an Bank Rate of 0.75% early next year – this seems unlikely.

Inflationary pressures expected to increase due to rising energy prices and supply / demand imbalance across markets.

Inflation is set to peak at around 5% next year and may only decline slowly. Oil prices have doubled to over $80pb in the last year and changes in wholesale gas prices in October is yet to be fully reflected in domestic energy prices.

Tension reflects global demand for energy outstripping supply; producers are keeping a tight rein on the latter. But these pressures should be transitory.

There is a similar picture visible in shipping costs, which are starting to decline from elevated levels. But the semiconductor shortage is expected to persist well into next year.

Labour force shortages contributing to inflation will not be resolved through interest rate changes

53k

HGV drivers lost in the UK since June 2017

1.5%

Contraction in the active labour force since early 2020

A sharp rise in interest rates will not affect the direct inflationary impact of these issues.

Excessive rise in interest rate adds to downside risks but an initial rise in interest rate may be inevitable and justified.

While an interest rate rise might be justified with the removal of some of the emergency Covid monetary stimulus. But supressing the economy with a series of interest rate rises adds to current set of downside risks.

In the coming months , the Bank will have to grapple with the unusual question of the appropriate monetary policy setting in the face of a shock that originates from supply-side constraints.

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Regulatory Output and Framework Changes

The recent 'Dear CFO' letter from Victoria Saporta continues the feedback from review of auditor, firms and other bodies in respect of auditor reports from 2021.

- Thematic findings on IFRS 9 expected credit loss (ECL) accounting informed largely by the experience of Covid-19, centres on model risk, economic scenarios, recovery strategies and benchmarking (Annex 1).
- Thematic findings relating to the global benchmark reform (Annex 2).
- How the PRA intend to use next year's round of written auditor reports to explore risks related to climate change on balance sheet valuations and material misstatement of financial reporting.
- Transition to alternative Risk-Free Rates and the management of operational and financial risks (Annex 2).

A key goal of the PRA is to see firms continue to develop their approach to IFRS ECL and that budgets and resource are made available to support such ends (see Letters from Sam Woods, 2016 and 2017).

4most launches UK mortgage essential spend model

Affordability calculation requirements for mortgage lenders in the UK are defined by MCOB. Affordability is one of the key constraints to lending in the owner occupied segment. A key component of affordability is establishing the customers essential spend.

Typically lenders are unwilling to require completion and evidencing of detailed income and expenditure estimates due to the friction this builds into the origination process. The regulator has provided guidance that a certain level of minimum spend must be assumed. Almost all lenders currently use ONS survey information to establish this minimum level of spend.

The key problems with ONS survey based models are that they:

- Do not differentiate between home owners and renters. Averaging across these groups is likely to under-estimate essential spend.
- Do not have sufficient granularity beyond income and family composition. Car ownership and other factors are also key drivers of essential spend.
- Is materially out of date; the survey information lags by 1-2 years. With key components of inflation rising this is likely to cause miscalculations.

4most have access to timely private income and expenditure data and have used this to solve the problems highlighted above identifying new segments that should be eligible to lend.

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Covid-19 impacts on data used in credit risk modelling

Since Q2 2020, the financial industry has been dealing with the 'live' impacts of Covid-19 – setting up payment holidays, preparing stressed projections of losses, applying PMAs to balance sheet impairments etc.

Throughout this period the use of data has been cautious with normal objective processes, such as monitoring and recalibration, being paused in favour of management overlays and risk acceptance.

As the impact of the pandemic outlook softens the use of bespoke account management actions and impairment overlays are reducing in line with internal and auditor recommendations.

The economic forecasts are returning to a more standard level and the concern of 'hidden losses' is reducing.

However, the trust in data from the last 18 months is still a point of concern. Across the industry we are still seeing model monitoring triggers at red levels with no action with commentary regarding the fact that it is 'due to covid' and stress testing models are still calibrated to the 2008/09 downturn as the last recession.

At 4most we are investigating ways to address these challenges and clean or adapt the data for use in various applications. The initial focus is on operation scorecards, IRB, stress testing and IFRS 9 with split considerations across snapshot and performance data. The below summarises our current investigations and thinking at this stage with more detail published on our insights page.

Scorecards

Use imputed outcome for performance based on:

- Credit Turnover shock
- Outcome at end of PH
- Scaling shorter outcome (early 2019 snap)

Cross tab analysis of behaviour pre, during and post Covid to create relationships to factor variables with consideration of segmentation

IRB Models

Include Long run analysis based on techniques for scorecards with large amount of conservatism to garner performance

May introduce uncertainty in to model builds and will require conservatism due to likely poor performance

Stress Testing / IFRS 9

Potential to use the adjusted data performance series with macro-economics. This may lead to the consideration of different variables when compared alongside previous stress periods

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