BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Dear Chair

Follow-up to PRA Statement on consumer credit

Background

1. The Prudential Regulation Authority (PRA) carried out a review of PRA-regulated firms' consumer credit lending in the first half of 2017, covering credit cards, personal loans and motor finance. The Financial Policy Committee (FPC) and Prudential Regulation Committee (PRC) were concerned about a continued period of material growth in consumer credit, a lowering of pricing and an extension of interest-free offers on credit cards. The review built on continuous supervisory assessment meetings and asset quality reviews undertaken in recent years. It provided the PRA with an up-to-date assessment of consumer credit underwriting and risk management practices across PRA-regulated firms with material consumer credit holdings.

2. Following the review, we published the PRA Statement on consumer credit on 4 July 2017. The Statement raised ten issues for firms to consider. Firms with material consumer credit exposures were required to respond to the PRA by September, with responses to be approved by Boards.

3. This letter communicates our key findings and sets out points for firms to action. Our main finding concerns weaknesses in management information and governance, with other findings covering medium-term economic risk; affordability assessments; and some product specific points on 0% interest credit cards; and on larger or longer-term personal loans and motor finance. The PRA will also communicate firm-specific feedback from the review to individual firms.

Findings

4. Most firms provided evidence of effective risk management and controls for consumer credit, and understood the risks in their business. We have also seen some early indications of firms tightening underwriting standards in 2017, such as raising scorecard cut-offs or reducing 0% credit card periods, though risks remain elevated and continued vigilance is required by lenders and the PRA alike.

(i) Management Information and Governance

The Board should set and endorse a firm's risk appetite, and have risk monitoring metrics

that are appropriate to manage that. The PRA expects there to be clear management information (MI) going to the Board, and for the Board Risk Committee (BRC) to discuss more detailed risk metrics, that the BRC Chair can summarise and present to the main Board.

The PRA and Boards have a shared interest in ensuring that management information (MI) is of sufficient quality and quantity to support oversight of the risks firms are taking.

Some BRCs do not routinely receive sufficient standardised MI on consumer credit to recognise when a shift in asset quality or portfolio performance is taking place.

The review found that firms with a retail focus tended to have a more effective coverage of mortgage credit risk monitoring metrics than for consumer credit. While mortgages are normally more material than consumer credit by asset value, losses in a stress are often comparable or even higher for consumer credit (in aggregate around 70% higher than for mortgages in the Bank's 2017 stress test).

The PRA also observed that much of the upward risk reporting to BRCs is done on an exceptions basis. To support effective oversight, more systematic reporting may be appropriate where consumer credit portfolios are material to a firm's business model.

Follow-up: *To ensure effective oversight of the risks their firms are taking, BRCs should consider whether, for consumer credit and other relevant banking products, their monitoring metrics are sufficient to aid protection against the following risks:*

1. Growth in product-level exposures or financial performance below requirements, which could build pockets of unintentional risk / unprofitable business.
2. Shifts in current or expected product-level risk performance which, given the nature of retail lending, can be difficult and slow to correct.
3. Downturns in new business performance or expected credit quality (eg expected loss) that suggest newer cohorts are lower quality and could lead to a shift in product-level performance.
4. Changes in the customer-level risk profile of new and existing customers (eg increasing indebtedness), which could suggest increasing vulnerability, that may result in weaker financial performance.
5. A build-up of concentrations in potentially higher-risk segments (eg lower credit scores; long-tenor loans), that may be masked by metrics that report product-level averages.
6. Expected performance under stress, to gain insights as to whether any risks generated by shifts asset quality might be amplified in a downturn.

The PRA will consider in late 2018 a follow-up review of the adequacy of consumer credit risk monitoring MI provided to Board and Board Risk Committees.

Board Risk Committees should also consider whether there are more general lessons on MI for all other banking products (including mortgages and corporate lending).

(ii) Medium-term economic downturn risk

5. The PRA Statement asked firms how they were seeking to ensure that underwriting adequately captures medium-term risk – a concern further reflected in the November 2017 *Financial Stability Report*. The FPC judged that lenders overall have been attributing too much of the improvement in consumer credit performance in recent years to underlying improvement in consumer credit quality and too little to the macroeconomic environment.

Findings:

- Firms acknowledged the PRA's concern that model projections may not adequately capture medium-term risks, given the recent benign economic environment and low arrears.

- We have seen emerging signs of a slight tightening in 'visible' underwriting standards, such as an uptick in loan pricing and a reduction in maximum 0% interest offer periods on credit cards (though these remain historically high).

- Many firms have also recently taken some steps 'behind the scenes' to provide greater allowance for the possibility of an economic downturn. There were differences in approach, in part reflecting different business models, but these steps included:

(a) Using crisis period data in risk models (or a higher projected unemployment rate);

(b) Raising the scorecard cut-off point for new business;

(c) Applying a 'prudent add-on' at the cut-off point;

(d) Using a return-on-equity hurdle rate that builds in a stressed buffer.

- Firms generally had more conservative policy rules for 'thin file' customers with limited credit histories, given the relative lack of credit performance data on those customers.

Follow-up: *The PRA will assess the resilience of firms' consumer credit books in 2018 (and beyond) as part of the ACS stress test and through firms' ICAAPs.*

(iii) Creditworthiness and affordability assessments

6. The PRA sought to understand whether firms had interpreted the FCA's Consumer Credit Sourcebook (CONC) prudently and consistently across products, whether data on customers' total indebtedness are included in underwriting (and/or ongoing risk management) for consumer credit products, and whether a potential increase in housing payments is applied in assessing affordability.

Findings:

- All firms attested that CONC was interpreted prudently, though many acknowledged inconsistencies in application across products.

- Most firms capture a borrower's total debt in application decisioning (although less so in ongoing risk management), and some firms are considering whether / how to align affordability assessments across consumer credit products (or else to ensure that the rationale for any differences is fully understood).

- In the context of the FCA's CONC review[1], many firms are considering whether to include a reasonably foreseeable housing payment increase within their affordability assessment, and if so how best to calibrate it.

[1] The FCA's Consultation Paper on CONC draws a distinction between a firm's credit risk assessment as a 'lender-focused' test, and affordability as more 'borrower-focused', while recognising that there may often be considerable overlap between the two. The consultation closed on 31 October 2017, and the FCA is currently considering responses.

Follow-up: *In line with the proposed changes to the FCA's Consumer Credit Sourcebook (CONC), unless a firm can demonstrate that it is obvious that the customer can repay in an affordable manner (eg where the customer is prime, and the amount and cost of the credit are relatively low), the PRA expects firms' affordability assessments to take account of income and expenditure, such as comparing net disposable income against monthly payments and considering the customer's total indebtedness. In such cases, where it is not obvious that credit is affordable, firms should consider whether a customer's housing payments are likely to increase over the period of the credit, and if so whether this could have a material impact on credit affordability. The assessment should be proportionate to the costs and risks of the credit and the borrower's circumstances, and in line with any updates to CONC.*

The PRA will liaise with the FCA as it develops its CONC Policy Statement.

(iv) 0% interest credit card offers

7. The PRA's review included an assessment of the assumptions that underpin income recognition for credit cards, especially 0% balance transfer products, and how firms manage the potential volatility in income arising from changes in customer behaviour. A key accounting decision for firms is whether or not to include future customer spending in valuations, and (relatedly) what expected life to assume.

Findings:

- For Effective Interest Rate (EIR) accounting on 0% interest offers, assumptions differed on expected life, retention rates and whether or not to include additional borrowing beyond the current balance outstanding.

- Assumptions relating to a longer expected life, higher retention rates and additional spend on balance transfer cards may result in higher income and asset valuations, but increase subjectivity and the risk of valuation errors. They also increase interest rate risk. Should customer balances amortise more quickly than expected, this could result in income being reversed out, weakening the firm's capital position.

- It was not always apparent to the PRA how, for firms making more subjective assumptions, this greater uncertainty had been factored into firms' valuations, risk management systems, capital held for behavioural risk or related financial disclosures.

- The PRA was encouraged to see some lenders considering Board-approved limits for interest income at risk, if customer balances amortise more quickly than expected.

Follow-up: *The PRA asks Boards to ensure they are content with their firm's EIR assumptions for 0% credit card offers, and understand the implications for income and potential income volatility (and related disclosures) if future customer balances amortise more quickly than expected. We also encourage firms to consider the use of interest income-at-risk limits, and to consider the contribution of credit card portfolios to interest rate risk when preparing their ICAAP.*

The PRA will undertake a broader review of EIR accounting across the industry, and beyond credit cards, in light of the move to expected credit loss accounting under IFRS 9. The move to IFRS 9 will mean that both interest income and credit losses will be impacted by customer behaviour. This review is likely to include a focus on how behavioural risk impacts capital resources and requirements.

(v) Unsecured personal loans

8. The PRA Statement asked firms to provide evidence of how their underwriting assessment and pricing of longer-tenor or higher-amount loans takes into account consumers' motivation for borrowing, and their overall indebtedness. Firms were also asked to explain how their approach to underwriting differs compared to shorter or smaller loans.

Findings

- The PRA was broadly assured that where firms have extended the amount and /or tenor of personal loans (in some cases up to £50,000 or/and out to 7-10 years), they have done so in a controlled manner. For example, allowing only higher-credit score customers to borrow more than £20,000-25,000, limiting the proportion of larger / longer loans within their total loans book (eg less than 2%), and making prudent assumptions around re-financing (eg not presuming the paydown of existing debt), and using enhanced credit checks of income and indebtedness for larger loans. This has (so far) resulted in lower default rates than firms' Unsecured Personal Loans average.

- Larger loans generally attract higher pricing (versus mid-sized loans of c.£7,500-15,000), though this is also explained by lower competition for larger loans, as well as firms charging a higher credit risk premium.

Follow-up: *For larger (>£25,000) or longer (>5 year) unsecured personal loans, the PRA recommends firms track the size and performance of these segments within regular MI. We would encourage 'layering' these features with higher-risk borrower attributes such as overall indebtedness, and also suggest firms consider introducing relevant concentration limits within their risk appetite metrics.*

(vi) Guaranteed Future Value (GFV) in motor finance, and stressed falls in car prices

9. The PRA sought to establish whether GFVs are set in a prudent manner compared with the expected future value of the car, to help appropriately mitigate lenders' exposure to losses in the event that used car prices fall materially. We also asked major lenders to estimate the impact on financial performance and capital from a fall in used car prices.

Findings:

- PRA-regulated firms providing motor finance have adopted a reasonably prudent approach to GFV setting, ranging from 85-95% of expected future value.

- Firms' stress tests tended to assume a smaller reduction in used car prices than the FPC considered appropriate for a severe stress, and seemed to be underestimating the potential for structural changes in the market to amplify price movements (eg the prevalence of Personal Contract Purchase deals and changing attitudes towards diesel).

Follow-up: *The PRA will consider what guidance on used car price stress to communicate to affected firms as part of the 2018 ACS stress test or ICAAP process.*

Yours sincerely

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