BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

PRA Statement on consumer credit

1 Introduction

1.1 The Prudential Regulation Authority (PRA) has undertaken a review of consumer credit lending, examining PRA-regulated firms' asset quality and underwriting practices for credit cards, unsecured personal loans and motor finance (the 'PRA Review'). This follows a continued period of material growth in consumer credit, a lowering of pricing and extensions of interest-free offers. The Financial Policy Committee's (FPC)[1] June 2017 *Financial Stability Report* assessed the risks to financial stability from these developments.

1.2 This Statement summarises the findings from the PRA Review, and outlines issues arising for PRA-regulated firms that provide consumer credit to consider and act upon.

1.3 PRA supervisors will write to firms with material exposures to consumer credit with a request to respond to this Statement. Firms' responses, together with the results of the 2017 stress-testing exercises, will inform firm-specific supervisory action by the PRA and system-wide policy decisions by the FPC.

1.4 Relevant information will be shared with the Financial Conduct Authority (FCA), and this Statement should be read in conjunction with the FCA's forthcoming consultation on its Consumer Credit Sourcebook (CONC).

2 Findings of the PRA Review

2.1 The PRA Review found that, in an environment of rapid growth in consumer credit, interest margins have fallen and there was evidence of weakness in some aspects of underwriting, so lenders are more vulnerable to losses in stress.

2.2 **Overall, the PRA judges that the resilience of consumer credit portfolios is reducing, due to the combination of continued growth, lower pricing, falling average risk-weights (for firms using internal-ratings based models[2]), and some increased lending into higher-risk segments.**

2.3 While the PRA Review did not find evidence that the growth in consumer credit in recent years has been *primarily* driven by a material lowering of credit policies or scoring, the aggregate growth plans of PRA-regulated firms may only be achievable with some loosening in underwriting standards, or further reductions in pricing, notwithstanding a likely 'optimism-bias' in firms' business-plan projections (8% per annum aggregate growth over 3 years for personal loans; 4% for credit cards; 5% for car finance). Moreover, the short maturities of consumer credit mean that the asset quality of the stock of lending can deteriorate quickly.

1 In its statement on 27 March 2017 available at www.bankofengland.co.uk/publications/Pages/news/2017/008.aspx, the FPC noted that "Consumer credit has been growing particularly rapidly. This could principally represent a risk to lenders if accompanied by weaker underwriting standards. The FPC judges that these standards should be monitored closely. It supports a review launched by the PRA into the credit quality of new lending by PRA-regulated lenders and a review by the FCA into its rules and guidance on creditworthiness assessments used in the consumer credit market." Risks from consumer credit were also highlighted in the June 2017 Financial Stability Review available at www.bankofengland.co.uk/publications/Pages/fsr/2017/jun.aspx.

2 For Category 1 firms, drawn balances have increased 8% in aggregate over the past two years, while RWAs have fallen by around 5%.

The PRA Review highlighted some concerns across all three consumer credit markets:

- **Firms' assessment and pricing for risk appeared to be overly-influenced by the current benign macroeconomic environment and historically low arrears rates.** Falling margins do not appear to have been accompanied by a corresponding improvement in the underlying credit quality of new lending.

- **Rising consumer indebtedness and its impact on borrowers' ability to repay their debt in the future was not always fully considered in firms' assessment of risk.** For example, underwriting assessments did not always take into account a customer's total debt (including secured), nor was this routinely monitored for existing customers. Further, underwriting assessments rarely assessed how future shocks (for example to housing costs) could affect borrowers' ability to repay.

- **At the cut-off point for new business, only some firms incorporated a 'prudent add-on'**. That is, where credit risk was deemed just acceptable to approve the application, some firms added an incremental amount of loss to that predicted by risk models, to provide headroom for marginal business to still be profitable in the event of an economic downturn, or if their models under-predicted the actual loss; however this practice was not done consistently across firms.

- **Risk management and controls for consumer credit products varied considerably between firms, as did management information (MI)**. For example, some firms had few metrics specifically to cover consumer credit risks, while others had targeted metrics to control exposure to key segments, such as 0% interest credit card offers, highly-indebted borrowers, high-value loans or marginal net present value (NPV) business. There was a related concern in some instances that board oversight and other governance practices may not have been sufficiently robust to control underwriting, overall asset quality or pricing-for-risk standards. For example, a series of incremental moves into higher-risk lending, which individually would remain within risk appetite but, over time, may add up to a substantial increase in risk-taking.

2.4 **More positively, information submitted by firms to compare performance and practices now with the pre-crisis expansion provides assurance that issues seen then are no longer widely present.** (The years from the late 1990s to c.2004 saw a rapid increase in consumer lending, based on expansive business models and lax underwriting standards, with increased acceptance rates across all consumer credit products, leading to a larger proportion of credit granted to higher-risk customers. Credit card industry write-offs were c.6.5% in 2006 and 2007, more than double the current rate, see Annex, Chart 1).

2.5 Some product-specific risks are outlined below.

2.6 For **credit cards**, some lines of business are becoming dependent on long-term 0% promotional offers (including balance transfers) to attract new balances, with longer interest-free periods (Annex, Chart 2), which raises two issues in particular:

(i) **Applying (Effective Interest Rate) accounting standards to 0% interest credit card offers involves a number of assumptions, which are uncertain**. The calculation of interest income and credit losses are typically sensitive to the future behaviour of customers, including the rate at which the outstanding balance is expected to reduce over time and the amount that is expected to remain outstanding once the promotional period has ended. Any unexpected changes in customer behaviour will therefore lead to volatility in net interest income (NII), including potentially the reversal of previously recognised interest income. It is unclear whether or not this sensitivity is currently being captured as a matter of course in firms' monitoring of interest rate risk. Where new business on 0% interest credit cards is only marginally profitable, it implies that firms will be facing losses if model assumptions turn out to be optimistic.

(ii) **The PRA is concerned about delayed recognition of credit losses for these products.** For example, the borrower's ability to service their minimum payment obligations during the promotional period may be a lagging indicator of financial difficulty. If undue focus is given to arrears during the promotional period as a predictor of loss, future credit losses may be higher than anticipated and may exceed future interest income. These concerns should be mitigated in part by the introduction of IFRS 9, a new accounting standard that applies from 1 January 2018, which requires firms in scope to use a forward-looking impairment model based on expected credit losses. The earlier recognition of losses under IFRS 9 is likely to lead to higher provisions when the standard is introduced, which should allow for a more transparent assessment of the profitability of these products.

2.7 For **unsecured personal loans** (UPL), interest rates have been reducing at the fastest rate among consumer credit products (for PRA-regulated firms, 40% of the stock is now below a 5% APR, compared with less than 5% of the stock 3 years ago, Annex, Chart 3), implying less income to absorb potential future losses.

2.8 The PRA Review also found examples of an extension in loan tenors (in some cases out to 10 years) and increases in the maximum size of unsecured loans (in some cases up to £50,000 or more). Unsecured loans of this size and/or tenor are relatively new, so there is limited historic performance data, which means that risks might be under-estimated. While longer tenor loans have lower monthly repayments (for the same amount borrowed), this may make them affordable for some customers, where they would not be under shorter tenors. These trends may also be causing a shift in consumers' willingness to borrow via unsecured loans, and influencing their overall indebtedness, which in turn could affect borrowers' ability to pay and (given the unsecured nature of personal loans) increase the prudential risks for lenders.

2.9 **Motor finance** has seen the fastest expansion among consumer credit products, where a key factor has been the growing popularity of Personal Contract Purchase (PCP[1]) deals, which now account for around 80% of gross flows for new dealership consumer car finance (Annex, Chart 4). PCP creates explicit risk exposure to the vehicle's residual value for lenders,[2] who typically offer a guaranteed future value (GFV) for the vehicle. Gross GFV exposure is estimated to be around £23 billion across the industry, and GFVs are typically set in the range of 85-95% of the vehicle's expected future value (with a minority higher than that). PCPs written at the high end of this range are particularly exposed to a significant downturn in the used car market, possibly outside historic experience (used car prices fell by up to c.20% in the crisis, before recovering). An initial fall in prices could lead to a surplus of used cars coming to the market, which could further weaken prices and cause material losses to lenders through their GFV risk.

3 Issues arising for PRA-regulated firms

3.1 Firms are the first line of defence against the risk of losses on these exposures. Given these findings, the PRA is requesting evidence from all firms with material exposures to consumer credit, of how they will – across consumer credit portfolios – ensure that:

(i) **Credit-scoring adequately captures medium-term risk**, especially at the current point in the economic cycle when customers' credit performance may have been supported by a benign economic environment. Firms should also consider whether today's 'new generation' of borrowers (without experience of higher interest rate environments) has implications for their credit-scoring models.

1 PCP deals are structured on the basis of a series of monthly payments, followed by an optional 'balloon' payment if the customer wishes to retain the car, set at the same level as the guaranteed future value (GFV).

2 Other types of motor finance lending, such as hire purchase or personal contract hire, also carry some indirect exposure to residual value (for instance in the case of default or voluntary termination).

(ii) **Stress-testing approaches do not under-estimate potential downturn risk**, by placing too much emphasis on the current (historically low) point-in-time arrears rates of the portfolios. Traditional arrears-multiplier models for estimating the impact of unemployment in a stress test may be unsuitable in the current environment: separate models to predict the absolute level of arrears in stress may provide a useful challenge to current approaches and a different view of downturn risk (see also Section 5 below).

(iii) **Any 'loss leader'[1] segments are explicitly reported and monitored**. This is especially relevant to (differing risk-segments of) 0% offer credit card customers and low-headline-rate personal loans.

(iv) **Consideration is given to whether, at the cut-off point for new business, a 'prudent add-on' is or should be applied**, such that default rates could be higher than that assumed before the business would be loss-making, bearing in mind the currently benign macroeconomic environment. Where a 'prudent add-on' is not applied at the cut-off point, and therefore the portfolio might be exposed to higher potential credit losses, firms should explicitly reflect the absence of conservatism in the new business assessment in their stress-test approaches.

(v) **The Consumer Credit Sourcebook (CONC) has been interpreted prudently in underwriting** and in a consistent manner across products, and firms should be satisfied that any differences between products have been consciously accepted and justified. Firms should also review their prudential underwriting standards in light of any future FCA updates to CONC.

(vi) **A borrower's total debt (including secured) is taken into account in the underwriting process**, and total debt is then monitored for existing customers where relevant to future credit or risk assessment processes or decisions (for example in behavioural scoring and capital models). In responding to this statement, firms should be able to explain to their supervisor their policy and process in this area, and be able set out any mitigating actions that are or could be undertaken to reduce credit risk. The PRA encourages firms to consider, on a proportionate basis, how their affordability credit assessments might accommodate a shock to borrowers' mortgage payments or rents.

(vii) **Firms' risk appetite, MI and governance frameworks are sufficient to oversee consumer credit portfolios, including controls embedded to prevent unintended drift in underwriting, overall asset quality or pricing-for-risk standards, and board oversight of this**. Boards need to have sufficient oversight so they are appropriately informed and comfortable with the risks their firms are taking. In support of this, boards should consider whether (and where) it would be suitable to seek assurance through independent assessment (eg internal audit / external review of evidence), to support business and risk management judgements. Through firms' responses to this statement, and other supervisory work, the PRA will form a view on the adequacy of governance practices within firms as related to consumer credit lending.

3.2 Firms should also ensure that the following potential issues on <u>specific consumer credit products</u> have been addressed and mitigated appropriately, and be in a position to provide the following evidence to their PRA supervisor:

(i) **For 0% interest credit card offers, firms should be able to justify the assumptions and time periods used for forecasting the NPV of new business**, especially where maturity experience is limited for longer-term offers. Firms should have an appropriate risk framework in place to manage the potential volatility in the portion of NII relating to 0% offers arising from changes

1 A pricing strategy whereby the product would not in itself be expected to make a net profit at the price sold, but where it could generate repeat business or stimulate sales of more profitable goods or services.

in customer behaviour. This should include a clear risk appetite and robust monitoring processes.

(ii) **For unsecured personal loans, firms should provide evidence of how their underwriting assessment and pricing of long-tenor or higher-amount loans takes into account consumers' motivation for borrowing, and borrowers' overall indebtedness**. Firms should also explain how their approach to underwriting differs compared to shorter-tenor / smaller loans.

(iii) **For motor finance, GFVs should be 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 (such an outcome would be consistent with cars being handed back at the end of a PCP contract at much higher rates than observed historically). Lenders should assess the ability of their motor finance books to withstand a significant downturn in used car prices, and the PRA will ask major lenders to estimate the impact on financial performance and capital from a fall in used car prices, in 10% increments (including stresses that are beyond historical experience), and share these results with the PRA.

4 Responding to the PRA

4.1 For firms with material consumer credit portfolios, supervisors are requesting evidence of how they are addressing these risks and concerns, and assurance that firms' own boards are satisfied with how the PRA's concerns are being addressed. Firms should cover the three consumer credit products highlighted above, with the level of detail for each product proportionate to their importance to the firm's business model and level of exposure, and include quantifiable evidence to support statements and assertions.

4.2 PRA supervisors will be available to discuss these issues further with affected firms.

5 Stress-testing of consumer credit portfolios

5.1 **The Bank of England will bring forward the assessment of stressed losses on consumer credit lending in the Bank's 2017 Annual Cyclical Scenario (ACS) stress test for the major firms**. This will inform the FPC's assessment at its next meeting of any additional resilience required in aggregate against this lending.

5.2 Given the historically low arrears rates, in the 2017 ACS firms were asked to consider if it remains appropriate to use traditional arrears-multiplier models when considering the impact of unemployment (versus a 'step-change' from the current level of arrears), and a question for firms was included on stressed impairment forecasts as a result of cross-product holdings.

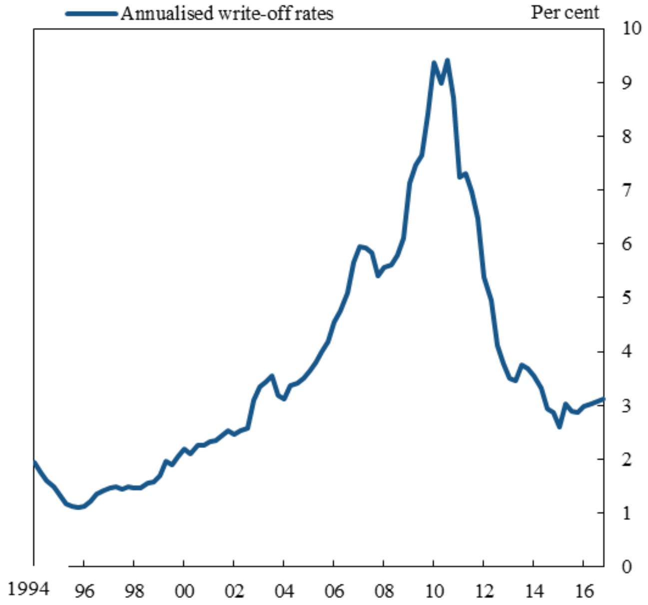
5.3 The extent to which firms consider, among other vulnerabilities, the recent cohorts of new business, borrowers with numerous sources of debt, the performance of maturing 0% credit card offers, and the impact on legacy segments will be central to the assessment. Results will be published and feedback provided to participating firms in the usual way.

5.4 The PRA will also work with firms not captured by the ACS stress test, but with relatively high exposures to consumer credit, to review their resilience against the 2017 (or similar) stress scenario, and provide feedback privately.

4 July 2017

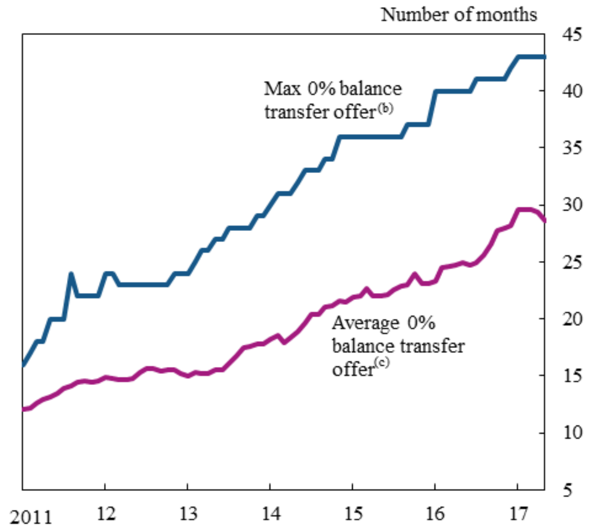
Annex: Charts

Chart 1: Industry credit card write-off rates



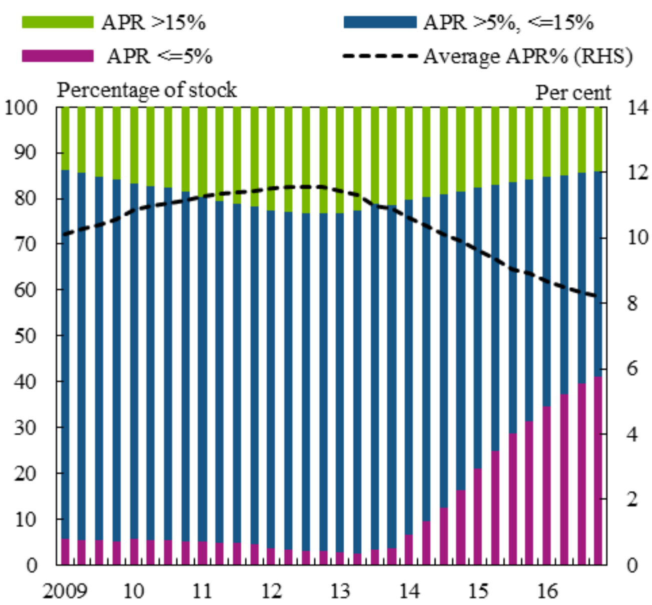
Sources: Bank of England and Bank calculations
(a) Lending by UK MFIs. The series are calculated as annualised quarterly write-offs, divided by the corresponding loans outstanding at the end of the previous quarter. The data are presented as four-quarter moving averages. Lending in both sterling and foreign currency, expressed in sterling. Non-seasonally adjusted.

Chart 2: Interest-free periods for 0% interest balance transfer offers on credit cards



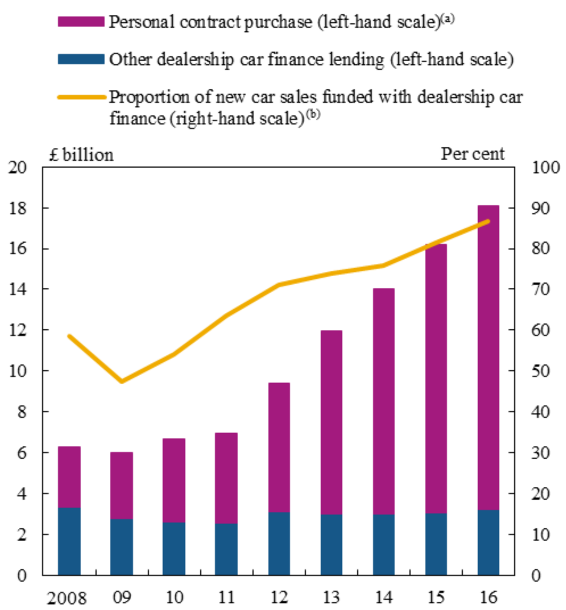
Sources: MoneyFacts and Bank calculations.
(a) Whole market end-month data, excluding values of zero and nil returns.
(b) The maximum 0% balance transfer term available across all lenders.
(c) The average 0% balance transfer term is the average of the maximum 0% balance transfer term available for each lender.

Chart 3: Annual percentage rate (APR) breakdown on unsecured personal loans



Sources: PRA regulatory returns and Bank calculations.
(a) Peer group for personal loan data is made up of PRA-regulated banks, representing c. 82% of the total unsecured personal loan market.

Chart 4: Value of annual dealership car finance for new car purchases, and proportion of private new car purchases funded with dealership car finance.



Sources: Finance & Leasing Association, Society of Motor Manufacturers and Traders (SMMT) and Bank calculations.
(a) Annual sterling gross lending to individuals on dealership car finance for new car purchases provided by Finance & Leasing Association members, attributed to personal contract purchase (PCP).
(b) Annual transactions on dealership car finance for new car purchases provided by Finance & Leasing Association members, as a proportion of SMMT new car registrations.