Risk adjusted pricing mechanisms will reflect changing capital requirements

Any increases in the regulatory capital requirements for credit risk will result in a higher overall cost of capital. Firms typically measure the impact of capital costs on portfolio analysis and pricing decisions using a combination of risk adjusted return on capital (RAROC) or Economic Profit (EP) metrics. In order to prevent longer term deterioration in RAROC and EP, lenders will need to consider covering increased capital costs from new lending. If the entire cost is passed to new borrowers, this will result in marginal borrowing costs increasing over the medium term or future lending being constrained further.

Our analysis of an indicative mortgage portfolio has shown that if forbearance results in a 10% increase in long term default rates and a 20% increase in economic losses (due to longer recovery timescales), the portfolio average RAROC will fall from around 40% towards 30%. If lenders choose to pass on these costs to consumers in order to maintain a constant level of RAROC, then mortgage rates would need to increase between 0.25% and 1.10%. The largest impact will be for higher risk lending with a 90% LTV mortgage of £100,000 costing an additional £1,100 per year in interest costs for the borrower.

Recommendations

We recommend that lenders should:

- Be able to identify "cured" customers within the performing portfolio, monitor their performance closely over time and assess how capital requirements are being impacted.

- Monitor the frequency of forbearance customers moving in and out of default and complete sensitivity analysis of their PD models to understand the potential impact on future PD model calibrations.

- Review their LGD methodologies to assess the risk and potential impact of forbearance on future LGD model assumptions and results.

- Complete a sensitivity analysis across all portfolios where forbearance is being applied, to assess the potential for increasing PD and LGD calibrations and the resulting impact on capital requirements over the medium term.

- Ensure they have a comprehensive understanding of how increased capital requirements could impact associated costs and review the potential effect on strategic portfolio analysis and tactical pricing decisions.

Conclusions

Forbearance offers potential benefits for both customers and lenders. However, as we have discussed, forbearance is far from the free lunch it might seem at first glance. Firms need to be aware of the hidden costs and additional risks associated with forbearance strategies, assessing whether:

- Unconsidered use of forbearance is placing customers **in further financial distress.**

- **Operations** teams are resourced and prepared to meet the new challenges at a time of heightened regulatory interest in conduct risk.

- **Impairment accounting** and **disclosures** accurately reflect the business positions.

- **Affordable new lending capacity** will be available for customers whilst achieving **Returns on capital** aspirations.

Lenders should prioritise and tailor solutions to fit with their strategic outlook, bearing in mind factors such as their market position or risk appetite. Improvements will require Operations, Finance and Risk functions to work together in each firm, taking account of the evolving regulatory landscape. However, failure to assess the medium to long term impact of forbearance could cause a good short term strategy to become a value destroyer, both for lenders and customers.

Deloitte.

Loan forbearance
No such thing as a free lunch