BDO FINANCIAL SERVICES ADVISORY

THE COST-OF-LIVING CRISIS A BRIEFING PACK FOR NEDS

November 2022

IDEAS | PEOPLE | TRUST

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INTRODUCTION

With the rate of inflation forecast to go as high as 13%, the downturn already looks like it will run deep, although for how long is still unknown.

The latest Financial Stability Policy Summary issued in June 2022 by the Financial Policy Committee projects an outlook of considerable uncertainty. Somewhat more optimistically, the BoE Monetary Policy Committee (May 2022) expects inflation will be back within 2% in the next two years. However, that may be too long for many consumers. With heightened regulatory pressure firms need to be prepared to ensure good outcomes for an increased number of customers in financial difficulty.

This briefing pack has been put together to help NEDs understand the prevailing conditions their firms are facing, with practical thoughts on how they might lead them through this challenging time. Our report includes an economic analysis as well as hot topics from our Regulatory Conduct, Risk and Governance, and Internal Audit teams.

We hope you find this information useful and if we can help further please get in touch.

Your sincerely,


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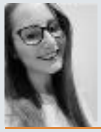
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THE ECONOMIC OUTLOOK

IMPORTANT NOTICE

BDO Economic Consulting has been asked to prepare an analysis of the consensus economic outlook (and our interpretations and views thereon).

This analysis has been prepared on publicly available information prior to the fiscal plan update from HM Treasury and Office of Budget Responsibility, now scheduled for 17 November 2022, and the November 2022 Monetary Policy Report by the Bank of England.

Those publications will provide crucial further direction for the UK economy in terms of fiscal and monetary policy as well as up-to-date insights into the likely state of the economy in the short and medium term.

UNCERTAINTY CONTINUES TO DOMINATE ECONOMIC COMMENTARY

Professional forecasters have revised their estimates for inflation upwards throughout 2022 – driven initially by supply chain disruption and the effects of war in Ukraine

IT HAS BEEN A YEAR OF ECONOMIC UNCERTAINTY AND WORSENING OUTLOOK

The chart on the right shows the evolution of CPI inflation forecasts made by a panel of c.30 independent forecasters – city institutions, international institutions like the IMF, and consultancies – as published monthly by HM Treasury[1].

Tellingly, 2022 inflation expectations have moved significantly throughout the year, and continue to do so, with a wide range of disagreement between the institutions (even in October 2022) on where the annual CPI inflation will land by Q4 2022.

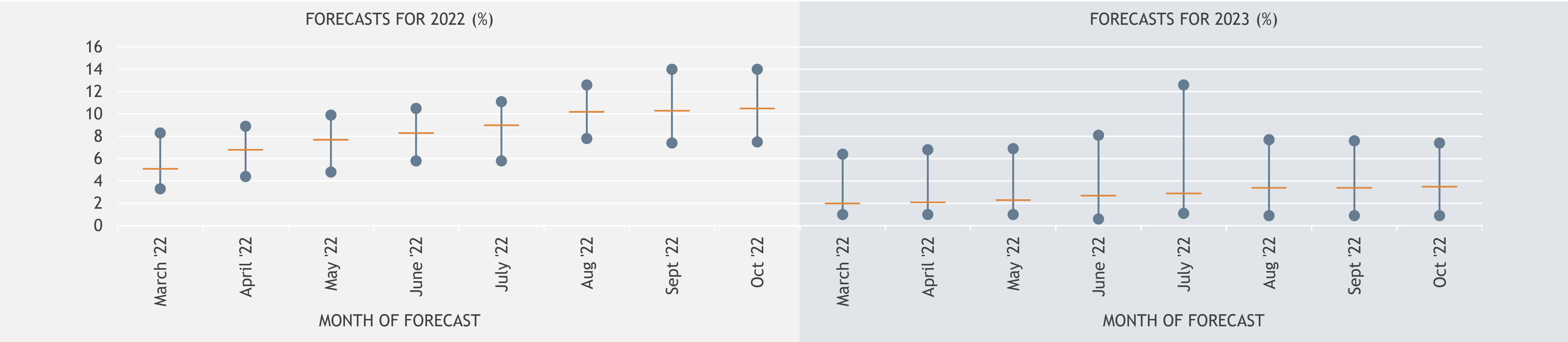
The charts also illustrate the evolution of forecasts for 2023. Early this year the median forecast (horizontal bar) was comfortably within the Bank of England's target range. However, as the year has progressed, a growing expectation of continued inflationary pressures in 2023 has built up. The highest independent forecast of CPI inflation for 2023 came in July at above 12%.

Notably, the median independent forecast for 2023 is significantly below the Bank of England's latest CPI inflation forecast of c.9% for 2023.

Even the highest independent forecast made in October 2022 for annual 2023 inflation, at 8%, is lower than the latest Bank of England forecast, made in August 2022, which may be the impact of the energy price guarantee being taken into account.

This illustrates the significant continuing uncertainty among market participants. Similar commentary applies also to forecast RPI inflation – incorporating housing costs that are absent from CPI. The latest range of RPI forecasts for 2023 ranges from 1.6% to 8.2%, with a median of 4.8%; i.e. 1.3 percentage points above CPI inflation.

CPI INFLATION FORECASTS FOR 2022 AND 2023, BY MONTH OF FORECAST[1]



1. Forecasts for the UK economy: a comparison of independent forecasts, HM Treasury, March 22 – October 22

UNCERTAINTY CONTINUES TO DOMINATE ECONOMIC COMMENTARY

Professional forecasters have revised their estimates for 2023 GDP growth downwards throughout 2022 – driven by expected consumer expenditure falls due to the cost of living crisis and interest rate rises

IT HAS BEEN A YEAR OF ECONOMIC UNCERTAINTY AND WORSENING OUTLOOK

Similarly to inflation expectations, independent forecasts of GDP growth in 2023 have:

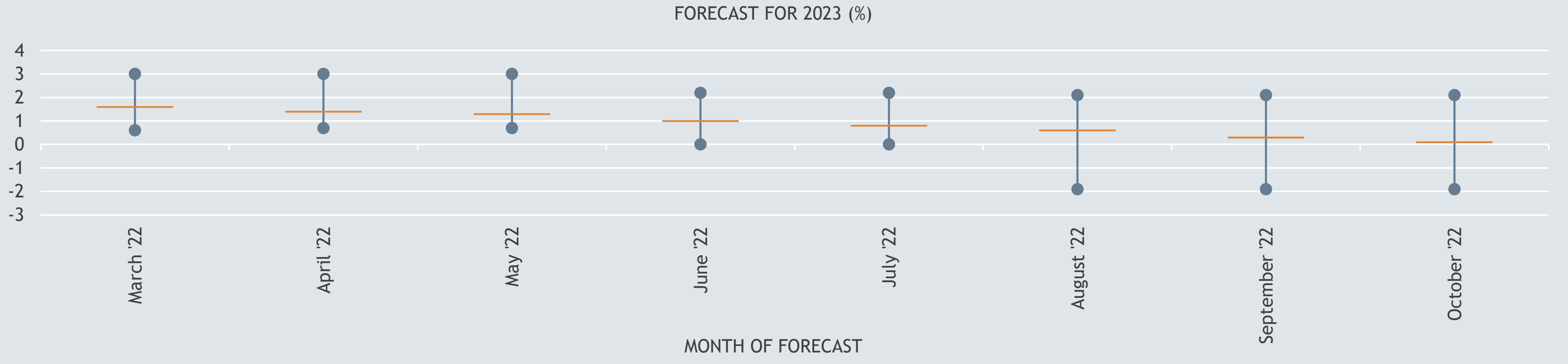
- Changed from March 2022 expectation of moderate growth to expectation of a recession in the latest October 2022 publication
- The range of forecasts has widened significantly, with some institutions still forecasting a positive growth for the year overall, highlighting the uncertainty of the situation.

The higher end of GDP growth forecasts may also reflect the fact that not all institutions submitting to the HM Treasury have yet updated their 2023 growth forecast – the figures published by HM Treasury each month include forecasts made in the last three months.

The median GDP growth forecasts for 2023 that were updated in October 2022 predict 0.1%. That remains significantly higher than the latest Bank of England growth forecast of -2.1% for 2023 (see next page).

This illustrates the significant continuing uncertainty among market participants and commentators.

GDP GROWTH FORECASTS FOR 2023, BY MONTH OF FORECAST[1]



1. Forecasts for the UK economy: a comparison of independent forecasts, HM Treasury, March 22 – October 22

UK ECONOMY IS NOW EXPECTED TO ENTER RECESSION BY 2023

The recession will likely feature high inflation combined with reduction in output (stagflation)

BOE CONSIDERS RECESSION IS HIGHLY LIKELY

BoE expects the high inflation to lead to a ‘sharp decline’ in household disposable incomes, leading to a fall in consumer spending, triggering a recession.

BoE’s August 2022 Monetary Policy Report is more pessimistic than the collection of independent forecasters above. It projects:

- UK output to fall by 2.1% in 2023; while
- CPI inflation to remain high at 9.5% in 2023.

Minutes from the September 2022 Monetary Policy Committee meeting, which took place before 23 September budget, projected worse outlook still with GDP expected to fall by 0.1% in 2022Q3 (vs 0.4% growth projected earlier).

The depth and length of the recession remain uncertain: the fan chart on the right indicates that the BoE projects a 15% chance that annual quarter-on-quarter GDP growth would be in a range around -5% in 2023.

Much will depend on fiscal policy responses and the Bank’s reactions to those with more clarity on both expected in November 2022.

BANK OF ENGLAND AUGUST 2022 BASELINE PROJECTIONS1

	2022	2023	2024	2025
GDP growth (%)	2.3	-2.1	0.0	0.4
CPI inflation (%)	9.9	9.5	2.0	0.8

BANK OF ENGLAND AUGUST 2022 GDP GROWTH TRAJECTORY - BASE CASE UNCERTAINTY[1]

Bank of England’s next Monetary Policy Report on 3 November 2022 will provide the next major update on economic outlook.

1. Monetary Policy Report - August 2022 | Bank of England

COST OF LIVING WILL RISE FURTHER IN 2023

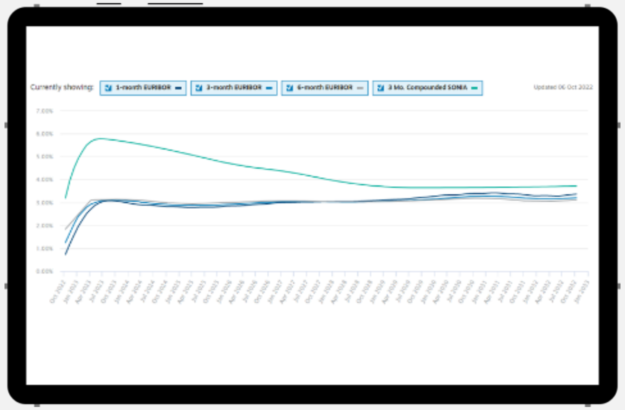
Continued high inflation may lead to upward pressure on salary expectations across the economy through 2023, impacting businesses across the board

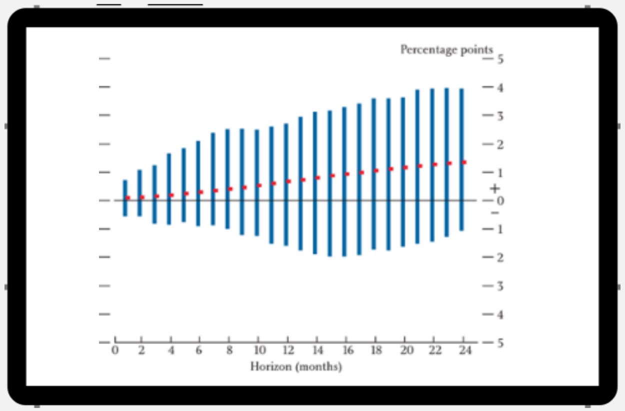
MARKET EXPECTS BASE RATES TO PEAK AT C. 4.8% IN Q2 2023, HIGHER AND STEEPER THAN EUROZONE...

...BUT THE MARKET HAS TENDENCY TO OVERESTIMATE FOR 8-MONTH HORIZON BY C. 0.5 - 0.75%

- Probable outturn, therefore, of c.4%-4.25% in Q2/Q3 2023
- But this is BoE base rate, not mortgage rates
- Typical spread over base rate of a five-year 75% LTV fix over past five years is 1.45%
- Mortgage rates implied of c.5–6% (depends on swap rates as well, but fixed mortgage rates reached at 5.4-6% in October).

NOTE: Comparison of market expectations vs actual turnout for different forecast horizons (blue) and average market forecast error (red line).





THERE ARE VARIOUS UPWARD PRESSURES ON COST OF LIVING

BoE CPI inflation expectations for 2023 currently at 9.5%, per previous page, although we would expect this to fall in the November 2022 Monetary Policy Report following the energy price guarantee, given that at present this is mostly supply side inflation, unless the BoE is unsuccessful in heading off a wage/price spiral.

Although consumers are insulated from further energy price inflation (albeit with prices being >2x what they were a year ago), businesses are less certain in this regard (shorter term guarantee) and other supply side inflation pervades.

However, key in people's considerations of overall cost of living will be mortgage and rent costs, which are not captured in CPI (rather they are contained in RPI, which is forecast c.1.3 percentage points higher than CPI).

Refinancing fixed rate mortgages and/or variable rate mortgages will be substantially more expensive – more than wiping out savings from energy price guarantee for typical home owners and further tempering consumer demand.

For a UK average mortgage (nationally, so will be higher in London and SE) of £137,000 over 25 years, this means:

- 2021 average five year fix rate of 1.58% equals £547pcm
- Payment at 6% equals £883pcm
- Increase of 61% on monthly mortgage bill.

The effect will inevitably bleed over into rental market.

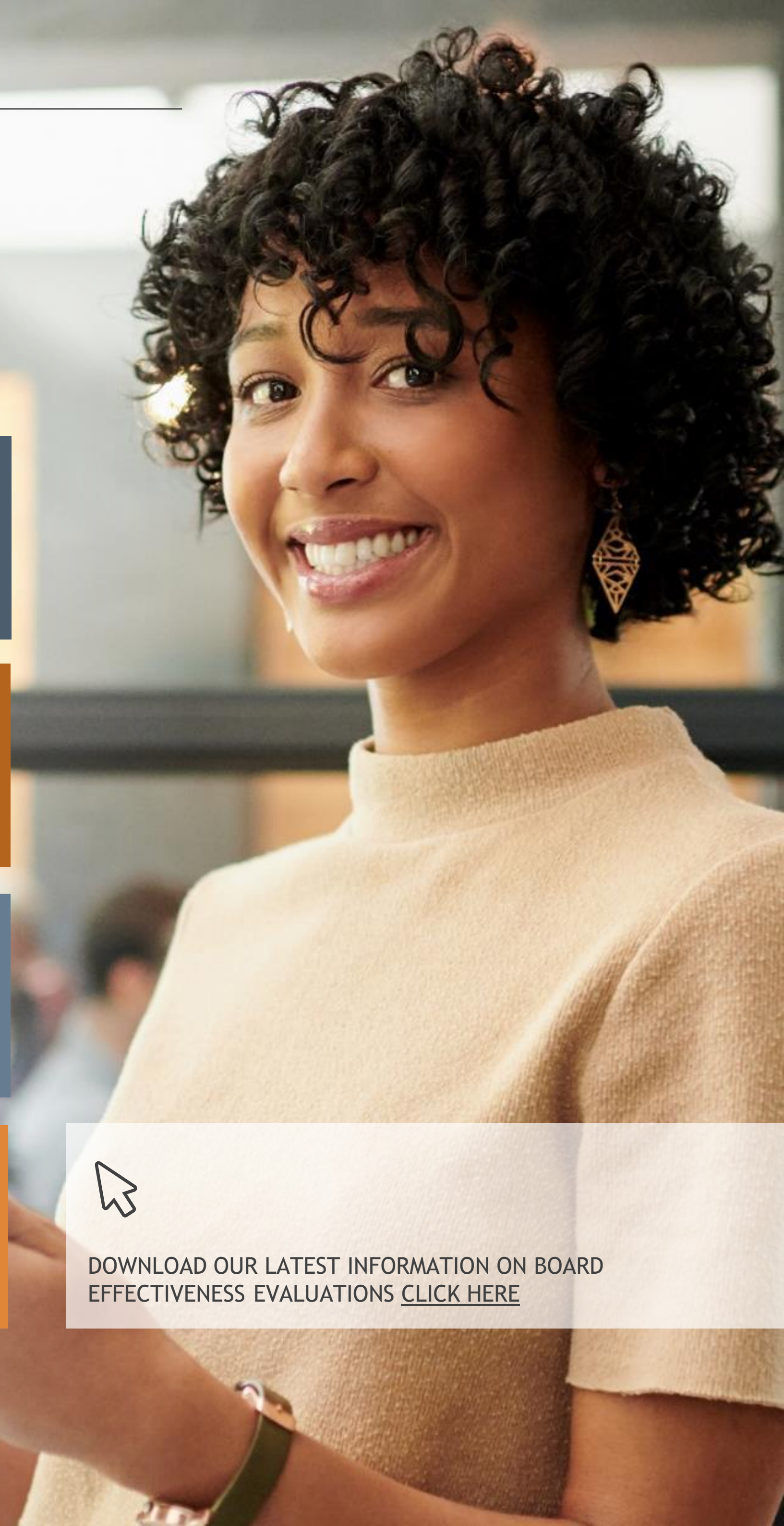
This, in concert with other inflationary pressures, will likely mean staff feeling the need to lobby for higher salaries and this will mean further pressure on businesses.

GOVERNANCE ARRANGEMENTS

GOVERNANCE ARRANGEMENTS

Strategic topics for Boards and Committees

- MONITOR RESOURCING LEVELS AND SLAS
- REVIEW THE FIRM'S RISK APPETITE, CURRENT SERVICE OFFERINGS AND PORTFOLIO WEIGHTINGS
- REVIEW CURRENT REMUNERATION ARRANGEMENTS AND SALES INCENTIVES
- ECONOMIC HEADWINDS CALL FOR A REVIEW OF STRATEGY TO ACHIEVE CORPORATE OBJECTIVES AND RETURNS FOR SHAREHOLDERS
- REVIEW THE CURRENT SUITE OF MANAGEMENT INFORMATION AND ENSURE OVERSIGHT IS APPROPRIATE
- ENSURE ROLES AND RESPONSIBILITIES ARE CLEARLY DEFINED
- CONDUCT REVIEWS - EG. OF CREDIT RISK MODELS AND EARLY WARNING INDICATORS - REMEDIATE WHERE NEEDED
- ASSESS THE EFFECTIVENESS OF BOARDS AND COMMITTEES



DOWNLOAD OUR LATEST INFORMATION ON BOARD EFFECTIVENESS EVALUATIONS CLICK HERE

GOVERNANCE ARRANGEMENTS

Top 10 questions for NEDs and INEDs to consider

01 Do we have an appropriate Board composition to navigate this crisis effectively, including experience in credit risk and an understanding of the economic and geopolitical environment?

02 Does the risk appetite statement, including supporting limits and key risk indicators require revision to take into account any changes in the business strategy, risk tolerance or risk exposure?

03 Do we need to consider the current volume of resources across the three lines of defence, including front line staff to deal with the impact of the crises on customers, but also across key support functions e.g. arrears management, collections and recoveries departments?

04 Do our internal credit risk models adequately capture changes in the macroeconomic environment, inflation, interest rates and performance of underlying industries or sectors?

05 Are we producing the appropriate MI to monitor customer outcomes most effectively, including identification of borrowers or groups of borrowers exhibiting signs of being in difficulty and/or posing increased credit risk?

06 Do our affordability calculations take into account rising living costs and higher projected interest rates? Are the figures we are using reasonable?

07 Are our current sensitivity analysis and stress testing models sufficient or do we need to consider more severe scenarios to anticipate further economic and financial market downturns?

08 Are our policies, procedures and modelling methodologies appropriate for identifying customers exhibiting signs of increased credit risk and treatment of such customers?

09 Are our remuneration arrangements and sales incentives appropriate? Do they meet the needs of our employees but ensure that poor conduct is not encouraged?

10 Do the Board and/or Board committees need to meet more frequently in view of current circumstances and do the Board require any additional training or briefings?

ARTICLE: THE ROLE OF INTERNAL AUDIT IN HORIZON SCANNING

THE ROLE OF INTERNAL AUDIT IN HORIZON SCANNING

Recycling last years' register is no longer adequate. Internal Audit needs to go beyond 'the expected' to take in broad and expert perspectives of what may be on the horizon. The nature of human decision making also has to be understood to avoid biases that can creep into the management of risk.

While Internal Audit teams in regulated firms typically focus on risks driven by the regulatory and legislative developments affecting the business, some of the most severe, and often pervasive challenges that firms face are non-regulatory: staff shortages, extreme weather, regional conflict, high interest rates, supply chain disruption, cyber attacks, and outbreaks of disease.

So the question is how well can Internal Audit enhance a firm's emerging risk assessment for such non-regulatory risks. Lets take pandemic risk as an example.

COVID-19 - DID YOU ANTICIPATE THIS IN YOUR EMERGING RISK ASSESSMENT?

Aside from the most ardent virologists, most of us did not predict the breadth, depth and longevity of the COVID-19 pandemic.

As soon as we felt we mitigated the virus by containing its spread and inoculating its worst impact on our health, we were hit by a variant of the virus, or repeat outbreaks – the road to recovery was uncertain and the UK has only recently moved from pandemic to an 'endemic' situation (former UK Secretary for Health, 19 June 2022).

Most regulated firms likely had some form of 'pandemic risk' on the risk register, typically flu strains we've previously experienced, e.g., SARs, avian or swine flu, with a model to consider different degrees of the pandemic's disruption to people, processes and technology.

However, these (pre-COVID) risk assessments had some common human-based vulnerabilities worth considering for your future emerging risk assessments:

- **Availability heuristic -** We tend to estimate the likelihood of an event occurring based mostly on our personal memory of past instances of that event. Unless your risk register is supported by objective analysis of historical trends, assessment of future risk events will be incomplete and very likely flawed in supporting your efforts to prioritise risks
- **Anchoring bias -** Our assessment of risk is often heavily 'anchored' by the first piece of information we come across. A helpful technique is to separate information gathering from your analytical activities; take a look at the facts after the majority of the information gathering exercise has been completed
- **Confirmation bias -** Our natural cognitive tendency is to view facts and form conclusions that confirm our existing beliefs, e.g., 'Pandemic prone viruses exist (risk), but serious outbreaks are rare (likelihood is low) and, thankfully, modern medical solutions have mitigated the most fatal diseases (impact is low) – our firm categorises this risk as Low in relation to other risks.' Our perception of viruses before COVID-19 was driven by our viewpoint within developed economies, which have advanced healthcare and social welfare outcomes. We have to proactively challenge the basis of our modelling assumptions using external sources of information and incorporating different perspectives
- **False consensus effect -** We generally believe more people agree with our view of the world and its risks than is the case as we tend to associate ourselves with family, friends and colleagues that buy into our consensus of thought. Its vital, in the pursuit of an independent and objective mindset, to sincerely seek differing perspectives. If you disagree with a perspective, challenge yourself to logically articulate why that perspective has an unsound basis or appears misinformed.

THE ROLE OF INTERNAL AUDIT IN HORIZON SCANNING

WHAT SHOULD INTERNAL AUDIT TEAMS BE THINKING ABOUT?

- Developing a risk register driven by the firm's known strategy, functional objectives and permitted activities is straightforward (in theory); attempting to identify external risks, entirely unconnected to the firm's operations, plagued by our innate human biases could appear to be an impossible task.
- However, rather than attempting to map every possible event that could ever happen, an appropriate strategy could be to open up your emerging risk assessment process to sources of information and perspectives beyond your immediate peer group and sector. Internal Audit teams should consider:
  - Establishing a horizon-scanning working group within the firm, drawing on staff from across the three lines of defence, to consider the current processes in place to identify sources of risk information. This helps incorporate information from outside the Internal Audit team
  - Sharing information and best practice with Heads of Internal Audit drawn from across your sector, for example, thematic events organised by the CIIA which also include subject matter expert speakers. This evolves your process by incorporating information from beyond your firm's perimeter
  - Membership to risk forums that gather views from the wider economy and national security updates made available to the private sector. One example is the Centre for the protection of National Infrastructure (CPNI). The CPNI incorporates the impact of the National Security Strategy, National Risk Register and the UK's Counter Terrorism Strategy for regular risk updates and best practice guidance. Now your emerging risk assessment process can consolidate information from national and international sources
  - Partnering with external experts, such as qualified advisors and professional futurists, that can entirely challenge your established emerging risk assessment process and facilitate a broader consideration or risks through advanced research and modelling tools not typically developed by regulated financial services firms. This further step could substantially enhance the value that the IA team provides through the business-wide risk assessment and help evolve the firm's broader approach in considering its resilience.

ARTICLE: WHAT DOES THE COST-OF-LIVING CRISIS MEAN FOR REMUNERATION COMMITTEES

WHAT DOES THE COST-OF-LIVING CRISIS MEAN FOR REMUNERATION COMMITTEES

BACKGROUND

The headlines have made difficult reading over the summer with the cost of energy rising rapidly and the concern about the pressure this places on many families' and firms' finances.

In this article we look at the role of the Remuneration Committee and the individuals within a firm for deciding remuneration policies and allocations this year.

There are two distinct aspects of this. Firstly, how rising prices may affect the profits a firm makes and therefore its ability to pay dividends or increase remuneration for employees. And secondly, how robustly a firm's governance, risk and control structure can reinforce values and culture. It will be paramount for firms to ensure the funds available for remuneration are adequately distributed and remain in line with the firm's business strategy and values as well as its financial performance and ongoing financial viability.

The UK financial services regulators, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have recently reiterated the importance of firms' duties to their consumers and reinforced that any alterations to remuneration should not made at the expense of customer good outcomes. Firms will now have to strike a balance between ensuring employees are adequately remunerated and motivated to generate financial performance and good consumer outcomes. For example, ensuring sales targets are only for affordable loans. This puts the strength of a firm's culture and control environment to the test.

WHAT THE CRISIS MEANS FOR FIRMS: CULTURE AND ACCOUNTABILITY

The FCA letter highlighted that 'individuals should be held accountable for their conduct, competence with a clear, strong, and evidenced link between behaviours and remuneration outcomes'. Particularly for senior management, firms will need to demonstrate and evidence that any increases have been made in line with the firm's cultural practices and employee conduct expectations.

Some of the important steps in creating and maintaining a strong culture include:

- Creating an environment of trust where employees can speak-up
- Creating an accountability framework where performance across a range of factors is measured and rewarded
- Ensuring diversity from a range of perspectives
- Monitoring and measuring outcomes to ensure these align with values.

WHAT DOES THE COST-OF-LIVING CRISIS MEAN FOR REMUNERATION COMMITTEES

THE FCA LETTER TO CHAIRS OF REMUNERATION COMMITTEES

The FCA recently issued a letter to the Chairs of all Remuneration Committees for Level One Banks, Building Societies and PRA designated investment firms on 2 August 2022. The letter set out the regulator's expectations regarding the setting of remuneration outcomes for the year and highlighted the impact the current crisis could have on culture.

The letter is a reminder that Remuneration Committees should have the outcomes of the Consumer Duty in mind and ensure senior management are accountable for delivering these. The FCA also noted that these areas of focus may be an area of interest 'in any firm-specific engagement' throughout the year. Consequently, firms may be required to disclose management information, reports, meeting minutes, policies, and procedures pertaining to remuneration arrangements at the Regulator's behest.

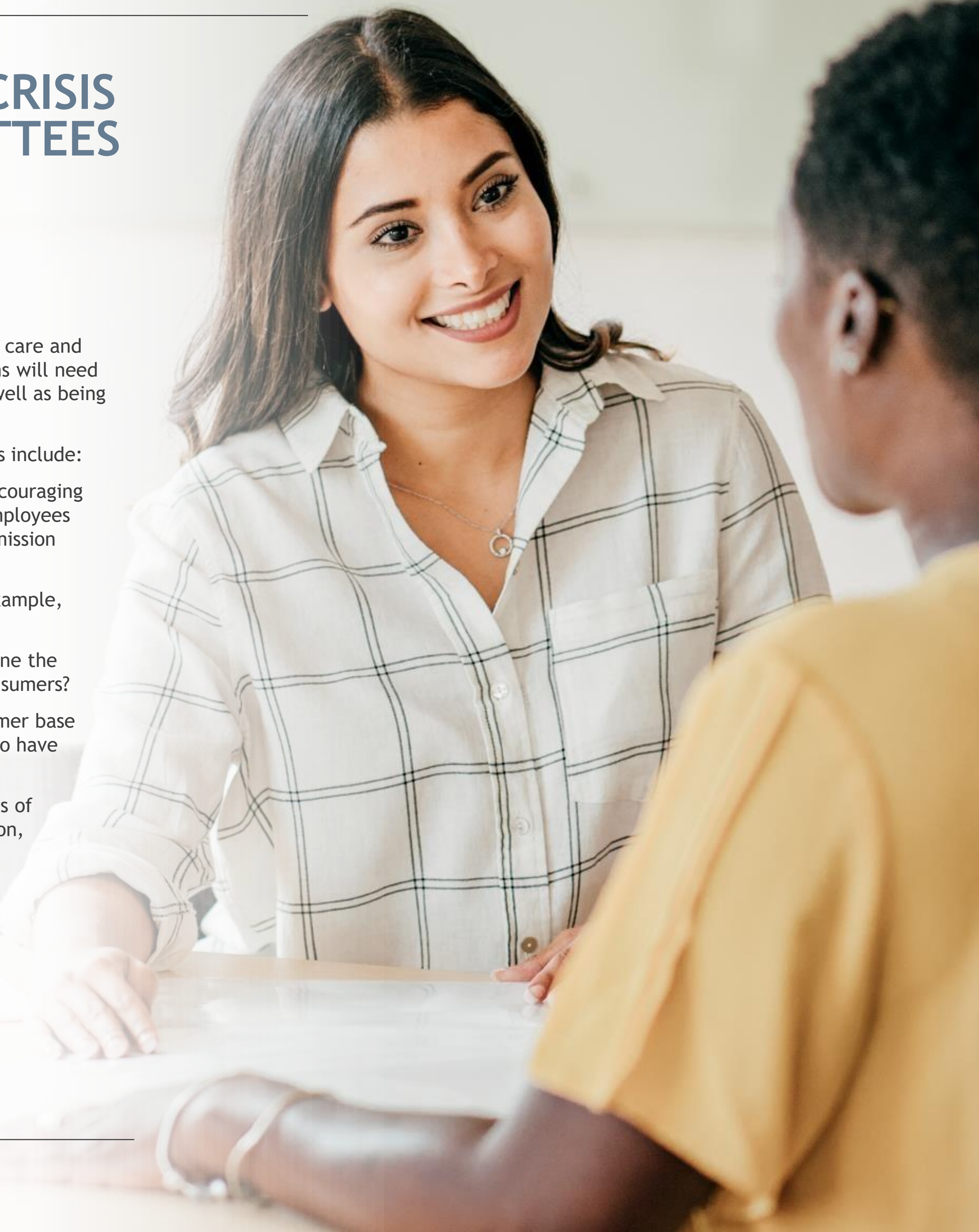
Firms will therefore need to make sure that their current arrangements are fit for purpose as well as ensure they are reviewed at regular intervals.

Key questions Remuneration Committees and senior management should ask themselves include:

- Are current key performance indicators ('KPIs') and performance reviews adequately balanced between financial metrics as well as non-financial metrics such as conduct, adherence to regulatory requirements and internal policies and procedures, customer satisfaction ratings, communication skills, teamwork, and leadership skills?
- Has the remuneration 'pot' been appropriately and proportionally allocated amongst employees that have met or exceeded performance targets? Are there any individuals who are currently disproportionally remunerated in comparison to their colleagues?
- Are there any conflicts of interests in the performance review or remuneration arrangements? For example, could individuals be recommending lower ratings to boost their own performance? Are c-suite individuals party to their own remuneration discussions and decisions?
- What message and tone will remuneration allocations send to employees and the wider market? For example, will there be an implication that the bulk of rewards are solely given to 'rainmakers' or senior individuals?
- Have recent employee satisfaction surveys or issues raised via the firm's feedback loops been considered? For example, has the firm considered the other benefits, remuneration options and support it offers its employees and how this may or may not assist them in this current climate?
- What MI is in place to demonstrate good consumer outcomes have been achieved alongside a strong financial performance?

Whilst firms may feel an increased pressure to remunerate staff to maintain current talent, it is likely that remuneration arrangements will receive increased attention and scrutiny from the wider financial services market and the regulators. Accordingly, firms and remuneration committees will need to be able to, now perhaps more than ever, be able to defend and justify any decisions made around remuneration or incentive arrangements.

WHAT DOES THE COST-OF-LIVING CRISIS MEAN FOR REMUNERATION COMMITTEES



WHAT THE CURRENT CRISIS MEANS FOR FIRMS: CONSUMER OBLIGATIONS

The new Consumer Duty outlines the FCA's new and higher expectations on the level of care and customer service provided to consumers throughout the product lifecycle. As such, firms will need to have a greater consideration for supporting customers through the current crisis as well as being alert to vulnerability characteristics.

Key questions Remuneration Committees and senior management should ask themselves include:

- What controls are in place to ensure that incentive arrangements or KPIs are not encouraging non-compliance with procedure or poor consumer outcomes? For example, could employees be pressuring consumers into buying a product or service to take advantage of commission or incentive structures?
- Do our employees fully understand their regulatory obligations to consumers? For example, can all employees clearly articulate these when questioned?
- Does our vulnerable consumer policy and wider policies and procedures clearly outline the classifications for vulnerability and the different options available to help these consumers?
- Have we considered the key impacts of the current cost of living crisis on our customer base and come up with realistic and appropriate means to offer support to customers who have indicated they are struggling?
- Are our complaints handling procedures robust enough to clearly identify root causes of discontent and where improvements are needed in the customer lifecycle? In addition, are complaints handling processes fair and in line with regulatory expectations?

THOUGHTS FOR LENDERS ON THE COST-OF-LIVING IMPACT

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CUSTOMERS IN FINANCIAL DIFFICULTY

There is likely be an increase in customers facing financial difficulty, many of these will be classed as vulnerable. Lending Firms will need to ensure that they have the capability, capacity and procedures to identify and appropriately treat vulnerable customers. Training will be critical to this.

NPAS AND ARREARS

There is likely be an increase in Non-Performing Assets and cases going into forbearance or arrears. Lending firms will need to review their early warning indicators and 'Watchlisting' policies and procedures. Firms will also need to ensure that arrangements are robust and consider the personal circumstances of borrowers.

COLLECTIONS AND RECOVERIES

Lending firms will need to prepare for the possibility of increased volumes but delayed or reduced rates of collections and recoveries. This means increasing capacity to handle volumes. Firms should ensure that they have adequately stress tested their liquidity ratios.

RISK APPETITE

While the market is changeable lending firms will need to regularly review their risk appetite. Firms should consider their exposure levels to certain products, sectors and markets, and geographical regions.

CREDIT RISK MANAGEMENT FRAMEWORK

Lending firms should review their current credit risk management framework and strategy, against the current climate. Firms should also ensure that they have adequate resource in place for monitoring credit risk.

MANAGEMENT INFORMATION

Lending firms will need to have a robust suite of management information reporting on key metrics. It may be prudent for firms to review their current reporting schedules to ensure that there is regular oversight with appropriate escalation channels.

MODELLING CREDIT RISK EXPOSURE

Higher cost of living will squeeze customer disposable incomes at the same time as interest rates make credit more expensive. Those two factors may not feature in lenders' credit risk models developed under different conditions. These will need to be updated for firms to understand the impact of the new environment.

GROWTH AND PROFITABILITY

The emerging high inflation and interest rate environment, and expected recession, will have fundamental impacts on customer demand, customers' ability to meet affordability tests, as well as the expected profitability of existing customer accounts. Understanding these impacts through credit risk and scenario modelling will be essential.

THOUGHTS FOR LENDERS ON THE COST-OF-LIVING IMPACT

The secured and unsecured lending sectors are under close scrutiny and we are expecting a perfect storm as interest rates and the cost of living rise simultaneously. The effects will be felt by retail consumers and businesses alike.

Rethinking an approach is the priority of government and regulators to avoid the worst fall out. Some of the challenges across the retail and commercial secured lending sectors are highlighted below.

RESIDENTIAL RETAIL MORTGAGES

With a decline in applications due to lower real disposable incomes and potential shortage of affordable products on the market due to higher base rates, mortgage providers may need to rethink products that better suit a higher interest rate environment.

Industry information already shows consumers are calling lenders and brokers about their options in advance of falling into arrears. Consumers facing difficulties in re-mortgaging may need different more flexible options.

Lenders need the capacity and capability to handle increased calls, provide sources of advice on managing household budgets, apply a robust and consistent forbearance policy which is affordable with appropriate credit risk analysis. FCA research shows the impact of quality and empathetic call handling on achieving good consumer outcomes for those facing financial difficulties. Lenders need to carefully monitor and consider their approach to consumers.

RESIDENTIAL BUY TO LET

Rental prices have been frozen in Scotland and this is likely to limit landlord income and could affect their ability to repay. In addition, there may be less demand for residential BTLs in Scotland. Lenders will need to consider their geographical exposure to such areas.

Landlords will also need to consider whether they need raise rents and by how much and their credit risk exposure to default across their portfolios.

HELP TO BUY

The Scheme is ending in March 2023 and there may be a ‘run’ on remaining qualifying properties, especially with the recent stamp duty reductions.

There is currently a lack of FCA or PRA guidance on such loans. This is a complex policy issue for regulators. Rising inflation will impact repayment ability. In April each year the interest rate rises by CPI +2%. There has been no government announcement on whether this will be the case for April 2023.

This could cause borrowers to fall into financial difficulty as CPI inflation is expected to be up to 10%, implying interest rates of up to 12% without changes to policy.

SHARED OWNERSHIP

Borrowers are technically tenants until they own 100% of the property. This means they are at risk of possession proceedings if they are unable to pay the rental part of the contract. Shared ownership housing associations may not have sufficient capital and liquidity to withstand high levels of default leading to risks to their financial resilience and sustainability.

COMMERCIAL - DEVELOPMENT FINANCE

As recession looms the cycle of development is likely to slow and we are seeing the share prices of property developers drop dramatically. There will need to be enhanced sector and market analysis will needed for proposed developments. Stress testing will need to take into account how badly these sectors have been impacted. Firms may wish to review their Risk Appetite Statement to place limits on geographical, sector and concentration. It is likely that the some sectors could be more adversely impacted than others, e.g., restaurants, cinemas, shopping complexes, offices.

INCREASED RISK OF FRAUD

The risk of fraud may be heightened given availability of financing options. Firms need to consider broader risks other than the financial or commercial rationale for a transaction.

GENERAL INSURANCE

GENERAL INSURANCE

Implications for insurers and their customers

Insurance and reinsurance companies and their customers face particular risks associated with the high inflationary environment, given that insurance premiums are typically set in advance of the risks being borne, and so the prices charged yesterday may not adequately reflect the claims of tomorrow.

In the following paragraphs, we look at some of these risks from the perspective of different stakeholders:

- When setting premiums, underwriters will need to ensure that the impact of the higher inflationary environment on insurance claims is considered, noting that the impacts will likely be different depending upon the classes of business being underwritten and the terms and conditions being offered
- When purchasing or renewing insurance, policyholders and brokers should have a clear understanding of the importance of the declared value (where physical assets are being insured) and the implications of under-insurance if the values are understated (which may lead to reduced claims settlement amounts)
- Claims managers will need to be ensure that customer claims are dealt with fairly and efficiently, but will also need to be alert to the potential for exaggerated or fraudulent claims which may increase as a result of the economic pressures faced
- When estimating the reserves, actuaries should ensure:
  - Explicit consideration, quantification, and communication of the expected impacts of inflation for different lines of business and types of claim
  - Quantification and communication of the sensitivity of results to key assumptions in respect of inflation
  - Reserving approaches are adapted where necessary, considering changes to:
    - The basis of the approach e.g. inflation-adjusted triangles, or frequency *x* severity
    - The segmentation of the reserve analyses, e.g. different heads of damage, or choosing shorter accident periods (months or quarters rather than years) so that variations in development patterns can be more easily assessed or reflected
    - Key assumptions, e.g. loss ratios and claims development patterns.
- Insurance company boards should ensure that inflationary risks are appropriately considered within their own risk and solvency assessments (‘ORSA’), including stress and scenario tests to inform their capital needs and management actions.

ARTICLE: THE CONSUMER DUTY, HOW TO TEST FOR GOOD OUTCOMES

THE CONSUMER DUTY, HOW TO TEST FOR GOOD OUTCOMES

INTRODUCTION

This is our fifth article in The BDO Consumer Duty Series, helping clients to develop their approach to the new regulation.

Here we look at how to test for the four Consumer Duty outcomes. You can read further articles in the series by clicking here.

AN OUTCOMES-BASED APPROACH TO REGULATION

'Principle 6' introduced an outcomes-based approach to regulation, where firms have been expected to ensure that customers are treated fairly. Many firms responded positively to this and now use measures of customer outcomes to drive their business in some way.

The Consumer Duty redefines the outcomes expected from firms and raises the bar on what 'good' looks like. So, even for firms who routinely test outcomes and use the outputs to make improvements, there is still work to align this to the new rules. And for those who do not, this will need to be established to demonstrate they are achieving good customer outcomes.

WHAT DO FIRMS NEED TO DO?

The Consumer Duty cross cutting rules will define the standards of outcomes a reasonably prudent firm is expected to deliver by; acting in good faith, avoiding foreseeable harm, and helping consumers achieve their financial objectives. The four consumer outcomes give further detail on expectations for the core elements of a consumer/firm lifecycle. Firms will need to demonstrate they are able to achieve good outcomes across these stages and to the standards set out in the cross-cutting rules. The needs of vulnerable customers also need to be met so that they can achieve the same outcomes.

THE FOUR CONSUMER DUTY OUTCOMES

Consumer understanding - consumers are equipped to make good decisions. Information is made available at the right time and is understandable.

Price and value - products and services should be sold at a price that reflects their value. There should be no excessively high fees.

Product and services - the firm's products and services should be fit for purpose. The terms match the target consumer needs and products and services work as expected.

Consumer support - customer service should be responsive and helpful. It should be as easy to complain about or switch and cancel products or services as it was to buy them.

These standards raise the bar by holding firms to an objective standard of a 'reasonably prudent firm' and because the cross-cutting rules give a more specific and forward-looking view of good outcomes. Boards will take responsibility for assessing that the firm is achieving these outcomes and report on this at least once per year.

The first stage for firms is to apply the four outcomes to their customers, products, and services. This involves knowing exactly where and how the firm has an influence on consumers. As we explored in a previous article, analysing customer journeys identifies the points at which firms impact outcomes. Firms also need to grasp the behavioural science that underpins The Consumer Duty so they are cognisant of how consumers make decisions and act. Once the firm has 'mapped' their business in this way they are then in a position to objectively test against the four requirements.

WHAT IS OUTCOME TESTING?

Outcome testing is a methodical approach of objectively assessing whether a system or process results in a defined outcome. It is typically used to provide evidence of desirable outcomes being achieved, or to indicate areas for improvement. Where impediments are found, outcome testing should also help to reveal causality, which can be rooted in culture, operational practice, processes, and policies. It goes beyond traditional quality control which tends to test only if processes have been followed.

THE CONSUMER DUTY, HOW TO TEST FOR GOOD OUTCOMES

HOW TO IMPLEMENT OUTCOME TESTING

While the principles of conducting a single outcome test appear straightforward, firms need to ensure a robust approach that provides meaningful and actionable insight across all areas. An effective framework will be built with the following components:

- Define a good outcome against the expectations set out in the Consumer Duty
- A complete map of in-scope touchpoints: all products, all services, and all customer types
- For each touchpoint all associated policies, systems, and processes
- For each touchpoint all sources of data identified and made accessible, including online, social media, consumer groups, charities and mystery shopping
- For each touchpoint an objective test (or set of tests) of the desired outcomes
- A method for measuring and recording the result of the test in a way that can be used to assess performance and to inform actions for improvement
- An appropriate methodology for root cause analysis, applied consistently
- Tools for capturing results in a way that can be aggregated and accessed for analysis
- Routine reporting to review performance and indicate areas of concern.

We have helped many firms realise the benefits of outcome testing, from the design and set-up of a new framework through to a fully managed service.

To find out more about how to implement outcome testing you can download our methodology here.

DOWNLOAD OUR OUTCOME TESTING METHODOLOGY CLICK HERE

ARTICLE: TEN PRACTICAL STEPS FOR THE COST-OF-LIVING CRISIS

TEN PRACTICAL STEPS FOR THE COST-OF-LIVING CRISIS

INTRODUCTION

This article looks at ten practical steps firms should be thinking about in the cost-of-living crisis and examines some of the challenges ahead.

The current cost-of-living crisis is causing stress to household incomes. Indebtedness, where debt becomes a burden rather than a facilitator, causes harm through stress and anxiety, persistent debt, and poverty. Indebtedness also has a long-term consequence if a negative credit score restricts future borrowing or access to mainstream credit.

The Joseph Rowntree Foundation Poverty report comments ‘Low-income households have less of a buffer against rising costs and any unexpected expenses, given they are less likely than any other households to have savings, with just over a third of people in the poorest fifth of households having liquid savings of less than £250 compared with one in six of the overall population.’

WHAT IS THE FCA SAYING?

The FCA is keenly focused on support for consumers in financial difficulty as part of the current crisis. The FCA is acting against firms who have fallen short of standards to help borrowers in financial difficulty. Firms in the lending and credit sectors will have already been under scrutiny by the FCA for both lending practices and providing forbearance support to consumers. That scrutiny is likely to increase with more focus on collections and repossessions as interest rates rise.

Dear CEO letters have been issued to the Lending, Insurance and Banking sectors as well as to buy-now-pay-later firms, reminding them of standards expected to ensure consumers receive a fair value deal and are treated appropriately during this very difficult period.

Retail consumers can also include small businesses. Firms need to examine how they treat small business customers when engaging in collections and recoveries for debt. Results of recent thematic work by FCA show this is an area that has fallen behind. Firms should be looking at how they treat SMEs in arrears and applying the same standards and thought processes applied to retail consumers.

Insurance is important and underinsurance can exacerbate financial stress for consumers. The FCA is keen for consumers to be appropriately insured but is reminding firms that fair value products, appropriate information and swift claims handling will be critical. A particular area that is called out is premium finance, typically used as a means of paying for insurance premiums monthly. Firms are asked to consider waiving fees, charges and interest payments and some products may be in breach of FCA rules.

TEN PRACTICAL STEPS FOR THE COST-OF-LIVING CRISIS

THE NEW CONSUMER DUTY AND COST OF LIVING CRISIS

One of the Consumer Duty cross cutting rules requires firms to avoid foreseeable harm to retail consumers. Avoiding foreseeable harm means looking ahead and planning. For example, firms may see a sudden influx of consumers with questions about their secured or unsecured credit, or seeking forbearance to help to manage their finances. Firms need to be prepared. For example, thinking about additional capacity they may need to answer calls promptly, updating call scripts or websites to signpost consumers to helpful and clearly communicated resources and ensuring they have access to suitable debt advisors or creating online innovative debt management tools.

The experience of the pandemic has given many firms in the lending sector time to work through the types of support they could provide to consumers such as interest free periods or payment deferrals. And whilst the level of repossessions has dropped, it would be prudent to think that this may increase. Firms should be walking through collections and repossessions processes and thinking about these through the lens of the Consumer Duty. Where services are outsourced, firms remain responsible and should retain clear oversight of processes, receive MI about consumer outcomes and take appropriate action. It is now time for other sectors to also think through the implications of the cost-of-living crisis. Much of the FCA's materials have a wider application and can provide useful insight.

DO FIRMS NEED TO THINK ABOUT HOW THEY COMMUNICATE WITH CONSUMERS?

A recently published research paper by FCA [Borrowers in Financial Difficulty, June 2022 prepared by Yonder Consulting for the FCA Borrowers in Financial Difficulty (fca.org.uk) gives an in-depth view consumers' experiences and is a valuable resource for firms to assess their own performance on delivering good consumer outcomes. The research found that whilst a majority (60%) of borrowers in financial difficulty had a positive experience of their contact with their lender, 39% had either a negative or indifferent experience. 'This was often based on the perceived capability of the individuals they spoke to at the lender, with greater positivity from these experiences where participants spoke to staff who appeared to be specialists in dealing with customers in vulnerable circumstances'.

The good outcome here for consumers is that they are supported in managing their debt. The best outcome is a sustainable ability to manage finances, but for some, hard decisions may need to be made to reduce debt. The research found that most consumers are reticent in contacting a lender because of negative perceptions or lack of knowledge. For example, believing contact would result in a negative credit score. Having made the decision to make contact, barriers that discourage consumers might include long call wait times or being passed around. The research makes the important point that the quality of contact with the lender's staff is vital in consumers engaging positively.

Empathetic and knowledgeable staff help consumers navigate their position. Key is listening to and understanding the customer's individual circumstances and identifying solutions tailored to that and providing clear information, for example, about the effects on credit ratings. What is also important is identifying those customers who may be vulnerable and treating them with additional care to ensure they receive the same outcomes. Being joined up and consistent in how services are delivered across the organisation and if possible, not having to provide the same information multiple times which can be challenging. Staff training and a supportive learning environment will be key as will metrics that focus on quality of consumer outcomes.

Conversely, negative outcomes will be achieved by failing to listen, insisting consumers make payments they cannot afford or failing to refer consumers to specialist debt advice where needed. Debt advice should be tailored to the consumer, options explained clearly, and solutions monitored to ensure they remain suitable.

Some common problems for firms include unclear or inconsistent application of forbearance, inconsistent waiver of fees, charges and interest, poor record keeping, pressurising consumers to pay more than they can afford or long wait times for calls. These issues will have a wide application across sectors. Where firms fall short and consumers lose out, the FCA will expect redress to be paid to consumers.

TEN PRACTICAL STEPS FOR THE COST-OF-LIVING CRISIS

01

Review the customer journey and look at the key touch points with consumers who may be in difficulty.

Where and how do customers approach a firm?

02

Check the basics. How easy is it for a consumer to make contact? Do phone numbers work, are they free?

How easy is information to find on a web page?

03

Is information easy to understand?

Are there unreasonable barriers for example extra forms to complete, small or complicated text or long wait times on calls.

04

Provide training and support to front line staff, this can be stressful for them to.

05

Review the approach to spotting and supporting vulnerable consumers - and is this easy to record and navigate for front line staff?

06

Look at capacity planning in those areas most likely to receive the most consumer demand. Identify where additional capacity can be found if needed.

07

Review product fees, charges and commission or payments to understand what could be waived or suspended if needed and think about how this can be consistently operationalised.

08

Check MI to monitor consumer outcomes or key risk areas such as numbers of consumers in difficulty and any issues with processes, products or communications that need to be addressed.

09

Have good QA or monitoring in place such as outcomes testing, call listening and consumer journey walkthroughs to pick up inconsistencies.

10

Review risk frameworks to re-assess risk tolerances, mitigation, and controls.

CASE STUDY

CASE STUDY

Barclays Bank UK PLC, Barclays Bank PLC and Clydesdale Financial Services Limited fined £26mn for failures in relation to their treatment of consumer credit customers who fell into arrears or experienced financial difficulties

BARCLAYS WERE FINED FOR:

- Failing to follow its customers' contact policies for customers who fell into arrears as a result 'many customers whose accounts entered into Barclays Collections experienced delays in being contacted by telephone and could have incurred additional fees and charges as a result of the delay' – Final Notice
- Failing to have appropriate conversations with customers to help understand the reasons for the arrears. The Final Notice noted 'Barclays also missed indicators of financial difficulty or vulnerability in a significant number of cases'
- Failing to properly understand customers' circumstances leading it to offer unaffordable, or unsustainable, forbearance solutions. The final notice noted 'Barclays also made errors such as delaying setting up plans, setting up plans incorrectly, mistakes with payments, and charging interest or fees during a breathing space hold on payments'.

> Consumers should feel reassured that their lender will work with them to help resolve any financial difficulties, whereas Barclays's poor treatment of its customers risked making these difficulties worse. Firms must treat consumer credit customers fairly, including when they find themselves in arrears.
>
> We will take action against unfair treatment, or where firm systems expose customers to the risk of unfairness. While this case predates the pandemic, this message is especially important as the impact of coronavirus continues to affect household incomes and budgets.
>
> MARK STEWARD, EXECUTIVE DIRECTOR
> Enforcement and Market Oversight, Financial Conduct Authority

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