the CREDIT PULSE

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MANAGING CREDIT RISK IN A DIFFERENTIATED DOWNTURN

In this issue of the Credit Pulse, we look at credit risk considering the macroeconomic and geopolitical trends likely to shape the financial services industry over the next six months. First, we focus on critical considerations for loan servicers in the post-pandemic era. Then, we discuss risk management practices for non-financial organizations that extend trade credit and institutions that arrange financing collateralized by it.

The impact of recent global recessionary pressures has been inconsistent across industries, sectors and regions — a phenomenon that can be observed in the contraction in residential real estate and ongoing strength in energy and healthcare — differentiating the economic downturn that is currently developing from those that have come before. Credit risks emerging against this backdrop make it imperative for credit risk managers to monitor forward-looking global macroeconomic indicators and their microeconomic effects. In the year ahead, credit will be influenced largely by geopolitical wildcards including the outcome of national elections and developments in the war in Ukraine and U.S.-China relations, the possibility of new black swan events, corporate earnings and monetary policy.

Lenders will experience pressures differently based on the composition of their portfolios. Mitigating them will require heightened attention to loan servicing in segments that are most impacted by the downturn. For banks, this means monitoring commercial and consumer portfolios at the geography, industry and product level with greater granularity than in the past, and proactively responding to potential deterioration. For non-financial institutions that originate credit — generally, trade receivables — in the regular course of business, more rigorous underwriting and monitoring will be necessary. Trade credit risks present a challenge for financial institutions that provide asset-based lending and/or underwrite securitizations, particularly with receivables as collateral. As such, these institutions should consider ways to help their corporate customers identify and address credit risks in their receivables portfolios.

A recap of global macroeconomic metrics in the year to date is presented in the table below.

Year-to-Date Global Macroeconomic Metrics

			Key interest rate target[1-7]	Inflation (Core Consumer Price Index (CPI), YoY)[8-14]	Unemployment[15-21]	Real Gross Domestic Product (GDP) (Annualized, QoQ)[22-28]
North America	U.S.	11/04/22	3.75% - 4.00%	6.60%	3.70%	2.60%
		12/31/21	0.00% - 0.25%	5.50%	3.90%	6.90%
	Canada	11/04/22	3.75%	6.00%	5.20%	0.04%
		12/31/21	0.25%	3.50%	5.90%	1.60%
Europe	EU	11/04/22	1.50%	5.00%	6.00%	2.40%
		12/31/21	-0.50%	2.60%	6.40%	4.80%
	U.K.	11/04/22	3.00%	5.80%	3.50%	4.40%
		12/31/21	0.25%	3.80%	4.20%	8.90%
Asia-Pacific	China	11/04/22	3.65%	0.60%	5.50%	3.90%
		12/31/21	3.80%	1.20%	5.10%	4.00%
	Japan	11/04/22	-0.10%	1.80%	2.66%	3.50%
		12/31/21	-0.10%	-0.70%	2.70%	3.90%
	Australia	11/04/22	2.85%	6.10%	3.50%	0.90%
		12/31/21	0.10%	2.60%	4.20%	3.90%

1 Press Releases, Board of Governors of the Federal Reserve System: www.federalreserve.gov/newsevents/pressreleases.htm.
2 Policy Interest Rate, Bank of Canada: www.bankofcanada.ca/core-functions/monetary-policy/key-interest-rate/.
3 Key ECB Interest Rates, European Central Bank: www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html.
4 Interest Rates and Bank Rate, Bank of England: www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate.
5 Announcement on Loan Prime Rate, the People's Bank of China: www.pbc.gov.cn/en/3688229/3688335/3883798/index.html.
6 Monetary Policy Releases 2022, Bank of Japan: www.boj.or.jp/en/mopo/mpmdeci/mpr_2022/index.htm/.
7 Monetary Policy Decisions — 2022, Reserve Bank of Australia: www.rba.gov.au/monetary-policy/int-rate-decisions/2022/.
8 Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average, FRED Economic Data: fred.stlouisfed.org/series/CPILFESL.
9 Consumer Price Index, 2000 to Present, Bank of Canada: www.bankofcanada.ca/rates/price-indexes/cpi/.
10 European Union Core Consumer Price Index (CPI): www.mql5.com/en/economic-calendar/european-union/core-consumer-price-index.
11 Consumer Price Inflation, U.K.: September 2022, Office for National Statistics: www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/latest.
12 China Core CPI Change, CEIC: www.ceicdata.com/en/indicator/china/core-cpi-change.
13 Japan CPI Core Core, Trading Economics: https://tradingeconomics.com/japan/cpi-core-core.
14 Australia inflation data has been provided on a quarter-over-quarter basis historically. Australia Trimmed Mean Inflation, Year-Over-Year, LanteanEcon: lanteancapital.com/indicator/australia/trimmed-mean-inflation .
15 Labor Force Statistics From the Current Population Survey, U.S. Bureau of Labor Statistics: data.bls.gov/timeseries/LNS14000000?years_option=all_years.
16 Statistics Canada: www.statcan.gc.ca/en/start.
17 European Union Unemployment Rate, Trading Economics: tradingeconomics.com/european-union/unemployment-rate.
18 Main Figures, Office for National Statistics: www.ons.gov.uk/.
19 National Data, National Bureau of Statistics of China: https://data.stats.gov.cn/english/easyquery.htm?cn=A01.
20 Statistics Bureau of Japan: www.stat.go.jp/english/index.html.
21 Labour Force, Australia, Australian Bureau of Statistics: www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia.
22 Gross Domestic Product, Bureau of Economic Analysis: www.bea.gov/data/gdp/gross-domestic-product.
23 Gross Domestic Product by Industry, August 2022, Statistics Canada: www150.statcan.gc.ca/n1/daily-quotidien/221028/dq221028a-eng.htm?HPA=1.
24 Euro Indicator: GDP, Eurostat: ec.europa.eu/eurostat/web/national-accounts/publications/news.
25 Gross Domestic Product: Q-on-Q4 Growth Rate: www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihyr/ukea.
26 China GDP Annual Growth Rate, Trading Economics: https://tradingeconomics.com/china/gdp-growth-annual.
27 Japan GDP Growth Annualized, Trading Economics: https://tradingeconomics.com/japan/gdp-growth-annualized.
28 Australian National Accounts: National Income, Expenditure and Product, Australian Bureau of Statistics: www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release.

Emerging golden age for loan servicing

Through much of the pandemic, lenders focused on meeting elevated mortgage demand stemming from the low interest rate environment and high demand for housing. Lenders met this demand with increased headcount initially and increased investments in process and technology transformation within originations subsequently. Now, as the government relief catalyzed by COVID-19 winds down, forbearances are ending, and we are experiencing an inflationary and rising interest rate environment. Tightening financial conditions have resulted in a cooling housing market and a significant drop in mortgage originations and refinance volume, which has dropped by almost 45% year over year.[29] These conditions necessitate a shift away from originations to servicing and loss mitigation.

Post-pandemic trends impacting servicers

The shift to servicing within the lending value chain requires servicers to consider the following external influences that may impact operations:

1. **Evolving macroeconomic conditions**
   - COVID forbearance moratoriums are ending at the same time the Federal Reserve has been aggressively increasing interest rates to curb inflation. The intersection of these events has heightened the risk of non-performing loans, delinquencies and foreclosures.
   - The portfolio growth many servicers experienced during the pandemic by participating in the increase in loan-servicing-rights opportunities will be accompanied by rising risk in an economic downturn. Servicers may be pressured to write down the book value of servicing rights transactions and build loss reserves, impacting profit and loss (P&L) statements.
2. **Demand for enhanced customer experience**
   - During the pandemic, lenders focused on originations-related customer experience. Servicing-related customer experience often was poor and, in some instances, inadequate. With increasing focus on servicing, customers are increasingly demanding greater transparency, personalization, and seamless transactions.
   - Fintechs are disrupting the servicing landscape with cloud-based software-as-a-service (SaaS) platforms, which provide efficient and dynamic customer experiences and integrated regulatory compliance.
3. **Increased regulatory scrutiny**
   - The Consumer Finance Protection Bureau (CFPB), Federal Housing Finance Agency (FHFA), Office of the Comptroller of the Currency (OCC), Financial Consumer Agency of Canada (FCAC), Financial Conduct Authority (FCA), European Banking Authority (EBA), Australian Prudential Regulation Authority (APRA) and other global regulators are increasing focus on fair treatment of borrowers, with special attention to servicers' management of customer complaints, collections, forbearance exits and loss mitigation processes. The CFPB recently issued mortgage servicing metrics on non-bank servicers highlighting areas where regulators are tightening scrutiny.

Protiviti has partnered with institutions to develop and implement short- and long-term measures, shown in the following table, to address these trends. Generally, we have observed greater success leveraging inoculation measures while planning for long-term transformation.

[29] "Mortgage Businesses Seen Laying Off Thousands as Volume Drops," by Carmen Arroyo, bloomberg.com, February 22, 2022: www.bloomberg.com/news/articles/2022-02-22/mortgage-businesses-seen-laying-off-thousands-as-volume-drops.

	Near- and medium-term inoculation opportunities	Long-term transformational opportunities
Evolving macro-economic conditions	• Clarify profitability drivers • Streamline reporting and analytics across client portfolio, identifying and focusing on customer segmentation strategy, loss mitigation strategy and customized customer service, including right-party contact and early-stage contact	• Build strong credit-rating-based client segmentation and scenario-driven adjustable models to quickly adapt to market conditions • Implement near real-time customer hardship solutions
Demand for enhanced customer experience	• Focus on digital offerings for routine customer processes (e.g., statements, payments, escrow, home insurance, etc.) • Ensure seamless loan servicing transfer experience • Leverage data and analytics for customer complaints prediction and management	• Invest in innovative customer interactions, customer self-service portal and omni-channel experience • Design data- and analytics-based customer engagement/experience/ customer 360-degree views • Strengthen use of artificial intelligence (AI) and machine learning (ML) for custom products and service offerings • Individualize marketing campaigns for customer retention
Increased regulatory scrutiny	• Establish dedicated function/focus for regulatory changes and push to specialists • Streamline risk and compliance reporting for proactive risk identification • Develop digital solutions for monitoring of key performance indicators (KPIs), key risk indicators (KRIs) and risk limits for real-time alerts, and addressing threshold breaches with corrective actions	• Implement data-driven evidence of compliance solution for regulatory requirements • Automate risk and controls testing where possible

Levers for greater efficiency and profitability

Loan servicers receive a nominal percentage fee for servicing their customers, with whole mortgage loans and mortgage-backed securities providing less revenue than their asset-based or asset-backed counterparts. Operating expenses — the cost of ongoing servicing activities, including managing defaults and loss mitigations — have increased amid an industry-wide shortage of qualified talent, squeezing margins. A well-run operation with higher performing loan portfolios and portfolio retention (i.e., low prepayments and payoffs) is essential for generating returns.

As servicers experience increasing levels of servicing needs and potentially a higher proportion of non-performing loans in their portfolios, they should focus on efficiency and effectiveness. Several levers can be applied to drive operational efficiency and improve operating margins:

- Enhancing self-service capabilities across consumer and commercial lending;
- Developing specialized training and implementing call monitoring systems and speech analytics solutions in call centers;
- Investing in advanced data and analytics to drive enhanced customer segmentation, targeting and service;

- Prioritizing smaller wins for transformational outcomes (e.g., policy/process changes, workflow automation, robotic process automation (RPA), etc.);
- Outsourcing routine, low value-added tasks, leveraging global resources to deliver operational resiliency; and
- Investing in technology transformation, including new-age digital platforms (e.g., optical character recognition (OCR), AI, big data, process management and workflow tools, workforce communication and collaboration tools, application programming interface (API) frameworks, and digital back-office).

It is important for lenders to conduct an end-to-end assessment of their servicing value chain, including processes/capabilities supporting performing and non-performing loans (as shown below), and identify optimization opportunities and the right lever(s). They can then perform a supporting cost benefit analysis (CBA) of these opportunities that factors in time to market and return on investment (ROI).

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Loan servicing value chain

Performing Services					Non-Performing Services		
Loan Boarding	Loan Administration	Customer Service	Investor Accounting and Reporting	Claims Management	Delinquency (DLQ) Management and Collection	Loss Mitigation	Real Estate Owned (REO) and Assets Disposition
• Loan setup • Post-boarding quality control (QC)	• Payments • Statements • Taxes and insurance • Document management	• Inquiry • Complaints • Servicing updates	• Remittance calculations • Advances management • Reporting • Reconciliation	• Claims prep and submission • Reviews and rebuttal • Loss analysis • Claims settlement	• DLQ monitoring • Borrowers contact • Collections	• Customer solicitations • Loan workout and modifications • Foreclosure • Bankruptcy (Chapter 7, 11, 12, 13)	• Asset repossession • Offer management and sale • Asset disposition

A call to action on non-FI credit risk management

Until recently, credit risk was a non-issue in most non-financial organizations that extend credit in the course of their business, as receivables were largely collected on a timely basis during a prolonged period of low interest rates. As a result, lax, ineffective or, in some instances, absent credit risk management practices posed few problems for corporates that provide trade credit or financial institutions that make asset-based loans secured by receivables to corporate customers and monetize receivables through securitizations.

But as economic conditions deteriorate, trade credit counterparties across many industries — particularly those that are most interest-rate sensitive, such as manufacturing, utilities and technology — may be at risk of defaulting, elevating the need for improvements to credit risk management and debt-servicing capabilities. In anticipation of potential economic challenges, corporates should be evaluating current practices against their base of customers who buy on credit to determine potential gaps and develop plans to strengthen their credit risk management functions, including triaging customers according to their risk level.

To anticipate customer delinquencies or the need to proactively amend payment terms, corporates should — at an industry level, or a customer level to the extent financials are public — monitor indicators of collection risk, balance sheet distress and/or bankruptcy. These indicators include, among others, liquidity, leverage (relative to peers and loan maintenance covenants) and large swings in working capital driven by accounts payable growth.

Credit risk mitigation strategies, such as requiring deposits or decreasing credit limits, may also be considered. Trade credit insurance may also provide some defense against growing credit risk, although providers may scale back or terminate coverage of certain customers or industries during periods of weakening economic conditions.

Common trade credit program gaps

Of the most common trade credit program shortcomings, the lack of a risk appetite-based credit policy requires the most immediate attention. Without an effective credit policy, corporates will struggle to shore up two other prevalent trade credit weaknesses: policy compliance and collections.

Outdated or informal credit policies should be revisited and institutionalized under a governance process that outlines underwriting criteria and management and board reporting requirements. Corporates can produce real-time reporting of concentrations and any potential collectability issues in the context of their risk appetite. Strong governance practices not only help to set initial credit limits and related approval processes, but also ensure effective ongoing monitoring and timely action on inflection points in the customer relationship lifecycle (e.g., requests for additional credit, performance issues, etc.).

Risk-based screening tools equip credit managers with flexible mechanisms to effectively assess an existing or prospective customer's ability to remit payment. This due diligence varies based on customer size, corporate structure, availability of public information, and requested credit limit and terms. Supporting technology and leverage of third-party vendors can help improve the speed and efficacy of underwriting. In some cases, goods and services should be withheld until a customer satisfies qualifying conditions.

A second weak point, non-compliance with credit policies, arises from inadequate governance practices and/or staffing, resulting in failures such as:

- Credit limit breaches.
- Incomplete analysis of documentation and related risks required for making credit decisions.
- Lack of independence from sales team in credit decisions.

Corporates must ensure processes exist to evaluate and make decisions about requests to exceed credit limits in a timely manner. These decisions may be based on a cap on credit limit breaches on a customer-by-customer basis and should include appropriate approval/escalation procedures for credit limit exceptions. Concentration and risk exposure analysis are key considerations in acting on requests to increase credit limits.

Inadequate collection practices are another common credit program challenge. Given generally strong performance in this credit cycle, many corporates do not have mature collection capabilities, as evidenced by understaffed collections teams that do not have experience working with distressed customers. As the increasing challenges in economic conditions coincide with the winding down of COVID-19 government relief programs, corporates must focus on reassessing their collection capabilities, which may include technology solutions. Common techniques utilized to prevent or respond to collections challenges include requiring letters of credit or guarantees from riskier customers.

Trade credit risk management infrastructure

Corporates can align their credit risk management frameworks to the following key risk management infrastructure elements:

Strategies and policies

- Governance overview, risk appetite and mission
- Risk assessment identification and planning
- Embedded credit risk management practices in business strategy

Processes

- Customer risk scoring, evaluation and determinants
- Evaluation tools and review/approval process
- Documentation for credit decisions
- Monitoring processes and mitigating tactics for the lack of robust financial reporting

Organization and people

- Delineated roles and responsibilities, including independent credit approval authority matrices
- Staffing levels and positional qualifications
- Trainings and development programs

Reporting

- Management/board committee reporting
- Issues and exceptions reporting and tracking
- Continuous monitoring and reporting

Methodology

- Customer risk scoring, evaluation and determinants
- Credit checks and other evaluation tools and models
- Concentration analysis

Systems and data

- Management information systems (MIS) reporting quality and independence, automation and data analytics capabilities
- Automated credit decisioning
- Collection tools

In closing

Leading corporate credit risk management functions are focused on maturing their operations across the key elements noted above. Institutions that offer financing facilities secured by receivables need to be aligned with their corporate borrowers on credit risk management practices that create confidence around the efficient collectability of the underlying receivables. This alignment will ensure corporates and their respective financial institutions maximize their returns and are well prepared to navigate more severe credit risks in 2023.

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