

Re-evaluating Loss Forecasting: A New Approach to Linking Macroeconomics and Affordability

Abstract

The purpose of this presentation is to instigate a re-evaluation in the way in which lenders model the relationship between the macro-economy and portfolio default rate. This relationship is important as it provides the means to incorporate forward-looking indicators into provision models to comply with IFRS 9 and enables firms to stress test their portfolios to satisfy ACS or ICAAP requirements.

Firms typically build regression models to link historic macro-economic trends with their portfolio default rates. Challenges exist as no two downturns are ever the same and portfolio trends are heavily influenced by company-specific factors such as changes to risk appetite. Government interventions and sustained periods of low interest rates have recently compounded the challenge further by producing unintuitive relationships with key economic variables such as base rate and inflation. These issues have led to reactive model redevelopment projects and/or post model adjustments to compensate for model weaknesses.

Rather than living with this problem, Jaywing has begun looking at alternative approaches to incorporating forward-looking indicators into financial models. This has led to us investigating the linkage between the macro-economy (and government policy) and the components of affordability: income and expenditure. The idea being that movements in macro-economic drivers will alter disposable income which will change the risk of a customer defaulting.

When affordability is assessed at loan application stage, the components of income and expenditure are sought and/or estimated to determine whether the customer can afford the loan. Under this proposed approach, a forecast of the income and expenditure components is made individually by linking them together with their economic drivers and/or government policy e.g. interest rate and mortgage repayments, inflation with essential spending such as food, welfare changes and benefit income. This generates forecasts of disposable income which can be used to estimate changes in default rate by drawing the relationship between disposable income and default rate.

The other advantage of this approach is that it can produce affordability forecasts at account level which can be used for other business purposes such as the identification of customers who are at increased risk of becoming vulnerable. This can then prompt the lender to proactively offer support packages to protect customers from any further financial harm.

Our presentation will explore this concept (cons as well as pros) with the objective of prompting the audience to challenge conventional thinking.

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