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Cost of risk high as global recession looms in 2023

Effective and proactive risk management is key to staying on top of the rising cost of risk, according to Slim Ben Ali and Akshay Amberkar. By taking advantage of new technologies, such as artificial intelligence (AI) and machine learning (ML), banks can improve their risk management capability and achieve greater value.

A large proportion of central banks across the globe have simultaneously hiked interest rates to tackle inflation in 2022. KPMG surveyed 356 CEOs globally across the financial services landscape, including banking, insurance and asset management for the KPMG 2022 Global CEO Outlook, to see how they are preparing for the near-term challenges while also looking at their priorities and concerns over the coming three years.

Nearly all financial services CEOs, 89 percent, agree a recession is inevitable in the next 12 months. The good news is the majority, 57 percent, believe the recession will be mild and brief. But that doesn't mean there won't be some economic pain. Earnings over the next 12 months could take a hit – half of financial services CEOs say it could be between 6 and 10 percent, while nearly a quarter think the impact could be greater, anywhere from 11 to 30 percent.

The IMF, FED and ECB have recently reiterated that banks take a prudent approach to the highly uncertain geopolitical and macroeconomic environment. While it is true that the positive effects of rising rates can offset some of the impact of weaker asset quality and higher funding cost, banks are advised not to be overly optimistic and keep monitoring the downside risks ahead. These include ensuring that their models have adequate adaptability and predictive capability.

Managing non-performing loans

Although it is not possible to know exactly how the current challenging market environment may affect banks' loan portfolios, pressure on borrowers is expected to intensify. This can lead to a surge in non-performing loans (NPLs) which often consume a bank's capital, management time and attention. They also decrease probability and undermine the viability and sustainability of a bank.

At the outset, the bank should update their customer databases with the latest accurate information.

Banks should also implement digital collection tools which can provide ease of access to the bank for repayment purposes. They should ensure that they will have enough capacity when needed to perform recovery and collection activities.

Banks are expected to be aggressive in managing their NPLs even if this involves bearing operational costs or crystallizing losses on a sale. While the majority of banks in the UAE are well prepared to deal with a higher level of NPLs, the situation might be different elsewhere. For instance, the required buildup of risk provisions in Europe cannot be covered by retained earnings and some of the European banks may need to tap into their capital buffers to mitigate the damage.

Prevention is better than cure

Banks should conduct a detailed downturn scenario analysis and identify major factors which are likely to hurt capital or earnings. The scenarios analysis may also consider the opportunities that the bank may have post-recession. Further, they should also develop an expense control plan for the downturn. This plan should categorize the banks' costs into the minimum needed for survival and to attain the strategic objectives of the bank. Having a plan in place will enable the bank to react to recession in an efficient manner.

The effective management of NPLs starts with a governance framework, an underwriting process and a sound lending policy at the time of origination. This involves developing more rigorous qualitative and quantitative standards when lending followed by effective proactive risk management which can help banks identify early warning signs.

History has shown that during recession, banks face significant pressures in managing their existing customer relationship and the risk of delinquency. Being able to understand the financial situation of each customer beforehand and act upon it with foresight can be a source of competitive advantage.

AI/ML can enable faster identification of risks from more valued sources, monitor customer behavior and adjust risk management strategies. More precisely, AI/ML powered solutions can help with predictive modeling and improve forecasting accuracy. This is crucial in time of crisis as traditional regression models

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cannot adequately capture non-linear relationships between the macro-economic environment and the finances of a borrower in the event of a stressed scenario. ML offers superior forecasting accuracy due to its ability to capital non-linear effects between scenario variables and risk factors.

Proactive and effective risk management to identify early warnings using analytics

Through the use of analytics, risk management systems can analyze large amounts of data to identify hidden patterns and measure the organization's current cost of risk. This type of data driven intelligence can be used to anticipate risks and to make appropriate changes in a bank's risk strategy.

Advanced analytic models are also useful to allow banks to measure the impact of mitigating actions and to understand the correlation between their risk management practices and their losses.

By leveraging these technologies banks can gain real time insight into risks and achieve a predictive advantage, helping them better identify and manage risks before they lead to losses.

In times of crisis, AI-driven credit decisioning can help the banks manage credit risk effectively in the following areas:

1. Credit assessment. AI can accurately help analyze a large segment of consumers and determines whether a particular customer is eligible for the loan.
2. Limit management. AI can enable dynamic limit monitoring which can help the banks in revising the limits on an on-going basis and even determine the maximum borrowing threshold based on pre-determined parameters.
3. Dynamic pricing. AI can help the bank achieve dynamic pricing which may enable banks to offer highly competitive rates and adjust pricing according to market shifts

AI and ML amplify many elements of model risk which are often insufficient to deal with current mechanisms and frameworks. During economic contraction and recession, external stakeholders from shareholders to regulators would seek reassurance that banks have solid early warning capabilities. This ensures robust credit monitoring and risk mitigation across the credit value chain. Banks can no longer rely on their current early warning systems which are based on backward looking indicators with a high number of false positives. They have limited time to adapt respond to the emerging scenarios.

Effective and proactive risk management also requires a change in mentality, and taking the right steps towards a culture of transparency and accountability.

The next few years may be challenging for banks, making the transformation of risk efficiency and effectiveness crucial for organizations with an aspiration to land on the right side of the credit cycle. Achieving this transformation will not take place overnight, and banks must take swift action to be prepared for a potential recession.

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