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Good Practice Lending Guide

RM01 Credit Risk Appetite

May 2024

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Contents

1 Introduction 5
1.1 Scope of this document 5
2 Bank of England (PRA) guidance 6
3 Elements of Credit Risk Appetite 8
3.1 Default risk 8
3.2 Affordability risk 9
3.3 Concentration risk 10
3.4 Fraud risk 11
3.5 Other risks 12
4 Exceeding Credit Risk Appetite – special circumstances 13
5 Monitoring and governance 15
5.1 Regular monitoring 15
5.2 Regular (annual) review 18
6 Example Credit Risk Appetite Statement 19
6.1 Introduction 19
6.2 Appetite framework 19
6.3 Risk acceptance criteria 19
6.4 Conclusion 22
6.5 Approvals 22

7 Appendix A - Grading approach to credit quality 23

7.1 Rule based grading 23

7.2 Score based grades 24

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1 Introduction

There is very little that businesses do that is entirely risk free. However, a business can make informed decisions about the type of risks it is willing to accept and what risks it wants to avoid in pursuit of its objectives. This view of what constitutes acceptable (and unacceptable) risk is captured within an organisation's Risk Appetite Statement (RAS) which in turn is part of an organisation's wider Risk Management Framework.

A RAS is a high level policy document, approved by the Board. A full risk appetite statement applies across all areas of the business and addresses all risks that the business faces. For example, IT risk, operational risk, liquidity risk, climate risk and for a lending business, credit risk. This may be in the form of one all-encompassing policy document or separate documents for each business area.

Specific to credit risk, the risk appetite statement for this could be one section in an overarching RAS, a standalone Credit Risk Appetite Statement, or an introductory section within the organisation's Lending Policy documentation. Whatever approach is adopted, the important things are that all business risks are covered and that all risk acceptance is approved by appropriately senior leaders within the organisation ie board level.

1.1 Scope of this document

The scope of this document, as part of the Good Practice Lending Guide, is credit risk ie the risks to the business that directly result from lending to a customer. Consequently, it describes the key elements that should be covered within a lender's Credit Risk Appetite Statement (CRAS) as a subset of an organisation's wider RAS.

Credit risk mainly happens as a direct result of the financial loss resulting from customers who don't repay what they borrowed as measured by arrears, default and/or write-offs.

However, other risks can come within the scope of credit risk due to the indirect losses resulting from lending activities. This includes risks around affordability (not lending responsibly), fraud risk and concentration risk that arises when a large proportion of lending is to borrowers with very similar geo-demographic or behavioural characteristics. Consequently, these risks are also covered within this document.

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2 Bank of England (PRA) guidance

The Bank of England (the PRA) is not prescriptive about what a risk appetite statement should look like. However, the PRA has provided guidance about its expectations for risk appetite statements in several CEO letters and other publications.

This guidance has been focused on new banks and larger credit unions[1,2,3] but the principles are universally applicable and should be applied proportionally whatever the size and type of your organisation. The key points that the PRA have made about credit risk appetite statements are summarised below:

- The credit risk appetite should be articulated as part of a formal risk appetite statement that has been agreed by the Board and is reviewed at least annually
- The risk appetite must be well defined and clearly articulated. This includes both expert/subjective viewpoints of what is an acceptable risk and indicators that are objective and measurable
- The appetite statement set by The Board should feed into the organisation's policies and operational procedures used to make lending decisions and manage customers
- The risk appetite statement should include reporting triggers. Typically, this will be some form of RAG status. When a trigger is hit the Board should have an agreed action plan to address the issue that has been raised
- There is a suitable ongoing monitoring of the risk appetite to assess compliance and identify any exceptions that arise
- There is a clear approval and reporting process for approving any lending that falls outside of risk appetite
- When applying these principles it is important to recognise how managing the desired risk appetite may require adaptions in the delivery cost incurred in implementing this effectively.

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[1] PRA (2017) PRA annual assessment of the Category 4 credit union sector. Assessment of Category 4 credit unions (bankofengland.co.uk)

[2] PRA (2017) PRA annual assessment of the credit union sector. Assessment of Category 5 plus credit unions above £15 million (bankofengland.co.uk)

[3] Regulatory Expectations. Regulatory expectations | Bank of England

Alternatively, they may need to formally acknowledge the compromise on risk mitigation based on cost constraints. An example would be only 30% of borrowers have a credit record that is consistent across all three CRAs and if a lender is only using one CRA view, balancing the cost of increasing to all three CRAs may be too costly to implement to give the full view and mitigate the risk of not having the full picture

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3 Elements of Credit Risk Appetite

In this section, we describe the areas that are often considered in a credit risk appetite statement (CRAS). The precise factors that are relevant to your organisation will depend on your organisation's objectives, product offerings and target market.

3.1 Default risk

All lending comes with a risk of customers getting into arrears or defaulting on repayments that may lead to losses for the lender. Each organisation will define its appetite for lending risk in line with its overall strategy and target customer groups.

Good practice in expressing your level of acceptable default risk is to include a mix of measures that relate to both the borrowing and repayment behaviour you expect from your target customer, and the target repayment performance of your existing portfolio of customers.

Some common examples of these measures are:

- Target customers - eg levels of arrears on other borrowing, County Court Judgement (CCJ)s, level of debt to income ratio, credit score benchmark
- Portfolio performance - measuring arrears rates such as percentage of live loans 1+ month in arrears, how many loans are defaulting and not paying at all, and how many loans are being written-off against the targets set for these in the business strategy plan

Some examples of how to include these types of measures into a risk appetite statement are:

- 'No more than 10% of loan balances should be granted to customers deemed to be high risk (credit score <550)'
- 'We never provide loans to people who have been bankrupt or have CCJs valued at more than £750 in the last 12 months'
- 'Overall portfolio 1+ arrears rate should always be below 5%'
- '1 year default rates (the proportion of cases defaulting in the 12 months after a loan is granted) should not be more than 2.5%'

The first two of these relate to target customers, while the last two focus on portfolio performance.

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3.1.1 Other factors impacting credit risk

Other factors that may be referenced in the CRAS include:

- **Loan term.** All things being equal, the longer the loan term the greater the risk of default. For very long loans with fixed interest rates, there is the risk that the funding costs of the loan rise, making the product unprofitable, even if the customer fully repays the loan. Even where funding costs do not change, a longer loan leaves more room for the macroeconomic circumstances, and therefore the borrowers' circumstances to change, or for the lenders' interest rates to be increased on new lending for specific products where there is in effect an opportunity cost for capital that is still out on loan with longer terms
- **APR.** The APR represents the balancing of two risks. One is that the APR is too low, resulting in losses for the organisation. However, if the APR is too high, this may result in low customer take-up and over-priced products that don't provide good value for customers. There are also new obligations for fair value in the FCA's Consumer Duty to consider here

3.2 Affordability risk

Responsible lending is a key principle captured in the FCA's Consumer Duty principle requiring lenders to treat customers fairly and provide good value. One feature of responsible lending is ensuring that the loan is affordable and does not result in financial distress for the customer.

Apart from the ethical implications, not fully assessing someone's ability to repay a loan, increases both the regulatory and reputational risks, as well as potential financial loss due to customer redress.

Common elements of affordability included with risk appetite statements include:

- **A disposable income buffer**. This is the amount of disposable income someone is expected to have left if they were granted the loan. It is calculated using the individual's confirmed (or estimated) income and expenditure, plus the value of the loan repayment. Typically, this will be expressed as a fixed amount (eg £50), as a percentage of income (eg 10% of gross income) or a mixture of the two
- **A stressing element**. This is to cover unforeseen life events or the impact of macro-economic factors such as rising food prices or jumps in utility bills. An additional amount is added to an individual's expenditure when calculating disposable income
- **Minimum income level.** Setting a minimum income acts as a backstop for those whose incomes are very low. For example, only lending to customers with a gross annual income greater than say, £16K
- **Conservatism**. Where there is more than one source of income or expenditure, the most

conservative value is chosen. For example, a loan applicant states their average income is £2,000 a month. However, the applicant's bank statement indicates that the true figure is closer to £1,950. This figure of £1,950 is the one that should be used

The acceptable level of affordability risk can be expressed in the values chosen for the above items. For example, a more risk adverse organisation may set very high thresholds for disposable income and minimum income. A less risk adverse organisation may rely entirely on disposable income, use a relatively small buffer, and have no minimum income requirement. For detailed guidance on affordability assessments see our separate module RM3 Application process.

3.3 Concentration risk

In most areas of financial services, concentration risk is usually about 'having all your eggs in one basket'. However, for specialist lenders, such as credit unions, it can also refer to lending outside of one's usual area of operation (for example a new employer partnership with an employer who ceases trading). This is because of the unknown risks or operational difficulties that this could entail.

Consequently, the risk appetite may include statements regarding the distribution of lending across different customer attributes and the range of products on offer. Some typical concentration risk considerations are discussed in the following sections.

3.3.1 Maximum loan amount

Setting a maximum loan amount limits the potential loss resulting from a single customer default. For organisations who grant larger unsecured loans, the maximum may be set to align with the FCA's definition of regulated credit (£60K). For credit unions, a key measure is the net liability of the customer (the amount of the loan, less their shareholding). If the net liability is equal or greater than £7,500, then this is defined as a large exposure[4].

3.3.2 Product mix

Different types of lending carry different risks. Therefore, lending may be constrained for some products to ensure a suitable spread across the different products on offer.

For example, a lender might have one product that is an amortising loan and another that is a balloon or bullet loan[5]. They state that they don't want to allocate more than 25% of their funds to bullet loans. This is because of the additional risk that bullet loans represent given that no capital is repaid until the very end

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[4] The Credit Union Sourcebook (CREDS 7.4) defines any individual exposure (net liability) of more than £7,500 as a large exposure. CREDS then goes on to define the maximum net liability for a single large exposure and the aggregate total of all large exposures in terms of the capital held by a CU.

[5] Amortizing means that regular repayments cover both capital and interest so that the loan is fully repaid by the end of the agreement. With a balloon (or bullet) loan, the repayments only cover interest. The full amount borrowed is repaid as a single "Bullet" payment at the end of the term.

of the agreement.

Similarly, a certain proportion of lending may be earmarked for existing customers vs new customers, with different terms offered to each.

3.3.3 Customer profile

A lender may be comfortable lending to a certain customer segment but would not want all their lending to be provided to that group. For example, lending to unemployed customers is acceptable if they satisfy all income and affordability criteria.

However, the lender decides to limit lending to the unemployed to say, 25% of their loan book. This is because they believe that unemployed customers are more sensitive to changes in the economy, and therefore this policy limits the lender's exposure to economic shocks.

3.3.4 Location and other geo-demographics

For some lenders there is a desire for customers to meet specific geo-demographic criteria. For credit unions, for example, lending should be to those who satisfy the 'common bond' that defines credit union membership. Often this will be locational (people living in one town or city) or occupational (teachers or steel workers) for example. Lending to people outside this definition creates risk because it fails to meet the 'common bond' principle.

For other types of organisations, the opposite may apply. Providing credit to people who are all very similar a risk because of the interconnected nature of people's lives. If a lender advanced most of their lending to employees of a single local company, and the company decided to relocate or went bust, then that could create a huge problem for the lender.

3.4 Fraud risk

Fraud is an ever present risk. In theory, every responsible lender has 'no appetite' for fraud and it may seem unnecessary for a lender state this position formally within their RAS. However, in practice there are always some cases of actual or attempted fraud even if these cases are difficult to detect.

By acknowledging this and making a statement of having a zero appetite for fraud it places an emphasis on lenders to implement a suitable fraud prevention framework to manage and monitor the level of fraud that occurs.

Note that fraud often occurs as a direct result of providing credit, ie first party fraud where the borrower takes out a loan with the intention not to pay from the outset, this is a credit risk.

However, operational risk of fraud is the risk of loss resulting from inadequate or failed internal processes, people, systems, or external events. Some organisations treat fraud risk as an operational risk rather than a credit risk.

3.5 Other risks

There may be other credit risk related items that lenders feel should feature within their CRAS. Consequently, consideration of new or additional risks should form part of the regular review processes that ensures that the CRAS remains current and up to date.

4 Exceeding Credit Risk Appetite – special circumstances

The CRAS defines a lender's appetite for credit risk. However, it is common for exception cases to exist where loans have been granted outside the risk appetite. This is normally on an exception only basis and there should be an established process for review and signing off loans of this type.

A common structure for managing this is to have a credit risk committee that convenes to consider applications outside of normal credit risk tolerance and carry out a formal documented process to accept or decline the loans.

In the event that loans are granted outside of the risk appetite without a formal process such as the example described above, this should be reported via the relevant governance forum with suitable explanations as to why the exceptions occurred and, if necessary, what action is being taken to tighten up operational practices that led to that risk occurring (see the next section on Monitoring and Governance for more details).

On review of cases like these, the business may decide to update the CRAS if those risks are now deemed to be acceptable.

Some examples of when lending might legitimately occur outside of credit risk appetite include:

- **Relationship management**: If the lender has a long-standing relationship with a customer who has a satisfactory repayment history, they may choose to override their credit risk appetite to continue providing lending services to that borrower in certain circumstances
- **Portfolio vs customer considerations:** The risk appetite may refer to the overall mix of the portfolio in terms of the portfolio's customer profile. For example, a credit union states that 80%+ of lending should occur in the geographical region in which the credit union operates. If this percentage was not achieved in the previous reporting period, they may decide to stop lending outside that region for the time being. However, if an existing customer moves out of the area and requests a further loan, they may override this policy if it is in the best interests of the customer
- **Consumer Duty/treating customers fairly**: Emergency circumstances can arise for applicants such as a home disaster repair, funeral expenses, or fleeing domestic abuse where coercive

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control has led to a credit history not of their making. In these cases, a lender may choose to override their credit risk appetite and minimum eligibility criteria for a product to provide the borrower with the necessary funds

However, it is important to fully evaluate and document when and why exceptions to the credit risk appetite have occurred. This is to ensure that the overall risk profile of the portfolio remains within acceptable levels. If significant numbers of exceptions are occurring, then a lender should consider one of two courses of action:

1. Modification of operational practices and/or greater oversight of existing practices to ensure that lending stays within risk appetite. For example, changes to lending policy or restricting an underwriter's ability to make decisions that lead to breaches of the credit risk appetite without senior management authorisation
2. Update the CRAS to align with operational practice. If the lender's goals or target market have changed, then this might result in a different view of what is deemed acceptable risk

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5 Monitoring and governance

5.1 Regular monitoring

Good practice is for the credit risk appetite to be a standard agenda item at Credit Risk Governance forums[6] held monthly or quarterly. To support this, a monitoring process should be created to assess compliance against all key elements of the CRAS.

The metrics reported as part of this monitoring should be clearly defined within the CRAS. For example, if the risk appetite states that customers with recent arrears or high value CCJs are not accepted, the monitoring should define exactly what is meant by these terms – how recent? How high a value of CCJ? Any arrears, or a specific threshold such as 60 days?

There are two levels of reporting/monitoring that are generally applied.

1 **Exception reporting.** This reports on specific cases that have breached the CRAS

2 **Aggregate reporting**. This reports on the wider status of the portfolio against portfolio risk metrics defined in the CRAS

We explore each of these in the following sections.

5.1.1 Exception reporting

Exception reporting focuses on specific breaches of risk appetite. Good practice is for the report to detail the specific risk item that has been breached, the nature of the breach, why it occurred, and importantly, what if anything the business is going to do in response to the breach.

In some cases, this could lead to significant changes in process, eg if defaults are being routinely missed in the CRA checks it may be timely to consider utilising a different CRA or seeing whether using two for marginal decisions is affordable.

An example exception report is provided below:

[6] This is a general term. Individual organisations may name their governance forums slightly differently but have similar remit. For smaller lenders, these items may be within the remit of regular board meetings.

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Credit Risk Committee: 14 May 202x Risk Appetite Exception Reporting. Presented by: Head of Credit Risk.			
Risk Appetite	**What happened?**	**Why?**	**Proposed Action[7]**
Minimum gross Income for applicants set at £15,000 PA. (Affordability risk)	A loan was granted where the customer had an income of only £9,000 PA	Underwriting override approved by the Head of Credit Risk, as all the other affordability criteria were met and evidence of a substantial lump sum becoming available (£20,000 inheritance) shortly after the loan would have been granted	None
Applications with defaults or CCJs of more than £500 in the last 12 months are declined. (Default risk)	A customer who had a CCJ of £1,750 four months ago was granted a loan	The loan was to cover a rental deposit for an individual who was likely to have become homeless without it. The CCJ was due to arrears following a period of unemployment. The applicant is now in full-time employment. They are also up to date with their two other active credit agreements and have not been in arrears in the last 3 months. Granting the loan was deemed to align with the organisation's social lending values. Decision was reviewed and approved by the Head of Credit Risk	None
Maximum single loan value of £5,000 (Concentration risk)	Three loans of £6,500, £9,000, and £7,000 respectively were granted	In all three cases, the new loans were made to joint applicants. Each applicant had a separate loan with us, and the new loan consolidated these separate loans into one, more affordable product with lower monthly repayments overall	Change to risk appetite to allow consolidation loans of up to £10,000 for a joint application, where the consolidated loans are all existing loans that the applicants have with us. Revised risk appetite statement to be taken to the board for approval at August 202x board meeting

[7] Good practice is to assign owners and target dates to each action which are approved by the committee and recorded in the meeting notes and/or actions log. Progress against actions is then reviewed at later meetings.

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5.1.2 Aggregate reporting

Where the risk appetite is expressed as an objective performance measure, such as a defined target arrears rate or default rate, then good practice is to define RAG statuses to quantify how well the risk appetite is being adhered to. An example exception report and associated RAG statuses are provided below:

Credit Risk Committee: 14 May 202x **Risk Appetite Status Report. Presented by: Head of Credit Risk.**			
Risk Appetite	**Status**	**RAG Status**	**Proposed Action**
No more than 10% of new lending to customers with credit score <575	4.2%	GREEN	None
No more than 20% of loans granted to the unemployed.	22.0%	RED	Review and tighten underwriting guidelines for unemployed applicants.
Portfolio arrears (1+ rate) no more than 5%	4.7%	AMBER	Carry out analysis to identify root cause of rising arrears with a view to tightening lending criteria and/or increasing pre-delinquency collections activity
Portfolio default rate no more than 2.5%	1.7%	GREEN	None
Maximum of £50,000 interest free (hardship)[8] loans granted each month.	£37,674 granted last month	GREEN	None

Credit Risk Appetite. RAG Status Definitions			
Item	**Green**	**Amber**	**Red (RAS Breach)**
No more than 10% of new lending to customers with credit score <575	<8% of loans	8-10% of loans	>10% of loans granted
No more than 20% of loans granted to the unemployed.	<15%	15 – 20%	>20%
Portfolio arrears (1+ rate) no more than 5%	<4%	4-5%	>5%
Portfolio default rate no more than 2.5%	<2%	2-2.5%	>2.5%
Maximum of £50,000 interest free (hardship) loans granted each month.	<=£45,000	£45,001 - £50,000	>£50,000

Note that some items may appear in both types of report, ie as individual exceptions and as aggregate

[8] These are loans that provide social benefit to support customers who would normally struggle to meet the repayments on an interest bearing basis. These are acknowledged to be loss making but are provided to align with the organisation's stated objectives in supporting these types of customers.

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portfolio measures.

5.1.3 Reporting over time

For both exception and aggregate reporting, good practice is to report on long term trends within the portfolio. This should be over at least 13 months to capture a full annual cycle but could be longer periods. This helps to spot emerging problems before RAG statuses are breached, and to see the impact of previous remediation actions.

5.2 Regular (annual) review

Monitoring your organisation's adherence to its risk appetite statement and taking any necessary remedial action should form part of the regular monthly or quarterly governance process. However, the risk appetite statement should itself be formally reviewed on a regular basis to ensure it remains up to date, with any amendments or enhancements incorporated into the review process.

Following the review, the credit risk appetite statement should be formally re-approved by the Board even if there are no material changes.

For most organisations, this will occur annually, although more frequent reviews can be undertaken if required.

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6 Example Credit Risk Appetite Statement

This section provides an illustrative credit risk appetite statement for a fictional lender, operating in the community finance space.

6.1 Introduction

This Credit Risk Appetite Statement outlines our approach to managing credit risk as a small to medium sized not for profit lender, serving sections of the community that might struggle to obtain credit from mainstream sources such as high street banks and building societies.

We serve people who live or work in the Anytown area, specifically who live in postcode districts XX1-XX20, or within 10 miles of the town centre.

6.2 Appetite framework

Our credit risk appetite framework aims to ensure that we maintain a prudent approach to lending while also being able to serve our target customer groups effectively. Our approach to credit risk management is based on the principles described in the following section.

6.3 Risk acceptance criteria

Our customer base is predominately people who are seeking loans to cover short term, unforeseen expenses such as buying a replacement washing machine or having their car repaired. Although, we will provide loans for any reasonable purpose to customers who meet our lending criteria.

Our customers typically have some degree of financial impairment or history of financial instability and tend to fall into the lowest four income deciles in the UK. Consequently, we have a medium risk appetite for credit risk as detailed in table below:

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Risk Area	Risk Appetite
Applicant population	We offer loans to individuals who have been UK residents for at least 12 months and aged 18 or over. We do not offer joint loans Given the different regulatory environments in some UK regions and the additional administrative overheads and risks that this represents, we offer loans to customers living in England and Wales, but not in Scotland or Northern Ireland Given our remit to serve the Anytown community, we actively seek to maintain 90% of our lending to people living within 10 miles of the Anytown town centre
Unemployed applicants	In line with our community objectives, we offer loans to the unemployed; however, they need to be receiving regular benefits, and have a minimum gross income of £15,000 p.a. To avoid over-exposure (concentration risk) the proportion of loans granted to the unemployed is limited to 15% of all loans granted each month
Previous credit history	We will not accept loan applications from customers with high value CCJs (>£750) or discharged bankruptcies that are less than 2 years old
Previous credit history	We will not accept loan applications from customers with recent serious arrears, defined as (3+ months in contractual arrears) or any CCJs in the last 3 months
Current credit history	We will not accept loan applications from customers who are currently in arrears with any live credit agreements with us or other lenders
Portfolio arrears rate (1+ month in contractual arrears)	The highest acceptable portfolio arrears rate is 10.0%
Portfolio default rate (3+ months in contractual arrears)	The highest acceptable portfolio default rate is 4.0%
Lending limits and terms	Based on the features and requirements of our target market, we have established lending limits to ensure that we do not overexpose ourselves to any single borrower. Consequently, we have set our lending limit to be £5,000 for any single loan, which can be repaid over a term of between 12 and 36 months
APRs	We apply risk based pricing to ensure that our products reflect the creditworthiness of our customers, our costs in servicing loans and deliver fair value for customers. Consequently, our loans are provided with APRs ranging from 26.8% to 42.6% depending on the creditworthiness of the borrower and the amount and term of the loan
Affordability	In line with our organisational goals and regulatory requirements, we have a low appetite for affordability risk. We adopt a rigorous and conservative approach to assessing each applicant's ability to repay their loans. We use open banking data were available to verify the applicant's income and expenditure. Where possible, we account for expected changes in income and expenditure over the loan lifetime to ensure it remains affordable over its full term. To ensure customers are not placed under undue financial stress, we require all customers to have disposable income of the greater of £100 or 5% of their gross income, taking account of the new loan, existing expenditure, and their repayments on any existing credit commitments
Fraud	We accept that fraud is a common feature within the financial services industry. However, we have zero appetite for fraud. Consequently, we have established robust fraud detection procedures to minimise the incident of fraud for our

	business. This includes rejecting any applications that match with UK sanctions or PEP databases.

We assess the credit risk of our customers using credit scoring that incorporates customer information obtained from a credit reference agency as well as information provided by the applicant themselves.

This is combined with decisions rules and manual underwriting where appropriate to establish a full understanding of our customers' circumstances before we decide whether to lend to them and the most appropriate terms under which to do so as detailed in our lending policy.

Based on analysis of our customer base, we have established credit scoring cut-offs that align with the arrears rate and default rate risk appetite stated previously. We only expect to grant loans to customers scoring below these cut-offs where there are exceptional or mitigating circumstances.

Monitoring and governance

We have established metrics for reporting adherence to our Credit Risk Appetite. This allows us to track any breaches of the risk appetite. Any exceptions to the following elements of the risk appetite will be reported on a case-by-case basis:

- Loans to residents outside of our residency policy (not living England and Wales for at least 12 months)
- Loans where the customer has not met our affordability criteria
- Loans where the agreed terms are outside of the permitted ranges (amount, t and term)
- Any cases where lending has been provided to individuals who have a bankruptcy or high value (>£750) CCJ recorded against them within the 24 months prior to their application date
- Any cases where lending has been provided to individuals that have been 3+ months in contractual arrears, in default or have any value of CCJ within the 3 months prior to their application date, or who are currently in arrears with any other credit agreement with us or other lenders
- Any cases of actual or attempted (near misses) fraud

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RAG status will also be reported against the following metrics.

Credit Risk Appetite. RAG Status Definitions			
Item	**Green**	**Amber**	**Red (RAS Breach)**
No more than 5% of new lending to customers with credit score <630	<3% of loans	3-5% of loans	>5% of loans granted
No more than 15% of loans granted to the unemployed.	<10%	10 – 15%	>15%
At least 90% of new lending is to residents living within 10 miles of the Anytown town centre.	>95%	90-95%	<90%
Portfolio arrears (1+ rate) no more than 10%	<7%	7-10%	>10%
Portfolio default rate no more than 4%	<3%	3-4%	>4%

These metrics will be reported upon at the monthly Lending Committee. Lending Committee is authorised and instructed[9] to:

1 Undertake further investigations and make any changes deemed necessary to our operational lending procedures to address breaches of the CRAS or where an amber or red RAG status exists

2 Propose amendments to the Credit Risk Appetite Statement for onward consideration and approval by the Board

6.4 Conclusion

Our credit risk appetite statement reflects our commitment to responsible lending and our focus on serving customers who may not have access to traditional forms of credit.

6.5 Approvals

This credit risk appetite statement was approved at the Board meeting held on 7 April 202x[10].

The policy will be subject to review and re-approval by the Board on or before 31 April 202x+1.

[9] This should be captured in the Lending Committee's Terms of Reference detailing the delegated authority to act.
[10] Approvals should be formally recorded in the meeting notes of the meeting.

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7 Appendix A - Grading approach to credit quality

Regardless of the type of assessment used to evaluate default risk, be it a highly automated system or a fully manual underwriting-based one, it is good practice to have clearly defined objective measures of risk that provide an assessment of the quality of the loans being applied for.

These measures are then available to support the risk appetite statement and to be used in the operational lending environment as part of the decision-making process to accept or decline individual loan applications.

A common approach to defining a measure of risk is to assign each case to a risk grade. The properties of each risk grade (arrears, default rates etc.) having been determined via statistical analysis of the performance of previously granted loans in each grade. For example, for risk grade 1, the proportion of loans that defaulted was 0.5% For loans in risk grade 2 the default rate was 2%, for grade 3 6% and so on.

In this example, if the CRAS includes criteria based on acceptable default rates, then the grading can be used to inform and report upon operational decision making and how that that aligns with the RAS.

7.1 Rule based grading

A common approach is to define risk grades based on a borrower's previous behaviour when using credit (ie their credit history)[11]

- **Very low risk (prime).** These are customers with an excellent credit history. No missing payments in the last 6-12 months, no previous defaults or county judgements (CCJs) and have never been bankrupt. Usually, there will also be evidence of completed credit agreements that have been repaid in full
- **Low risk (near prime).** These are still low risk customers, who are not quite prime. They will be up to date with their existing credit agreements, but they may have some minor history of arrears over the last 1-2 years. There will be no evidence of serious arrears (3+ months in arrears) in the last 2-3 years, and no defaults, CCJs or bankruptcies. They may however have had more serious arrears in the further past
- **Medium risk (sub-prime - light).** These customers may currently be in moderate arrears (<3

[11] A customer's credit history is usually obtained via a credit search at a credit reference agency.

months) and/or have a history of more serious arrears or low value CCJs within the last 2-3 years

- **High risk (sub-prime - heavy)**. These customers have an extremely poor credit record, with recent defaults, CCJs and bankruptcies. Often, they will be in arrears with their current credit agreements
- **Low-medium risk (new to credit)**. These are people without a track record of borrowing and repaying debt. For example, they may be young people who haven't yet had any credit accounts, or recent arrivals to the UK. Hence the term 'thin files' is used to describe these customers, due to the lack of data in their credit report (as provided by a Credit Reference Agency (CRA)).

  Eventually, they may fall into one of the above categories, but with no CRA information to work with, it's difficult to quantify the risk that these types of customer present based on their credit history alone. Therefore, the level of default risk may be determined via proxy.

  This could be using application form information such as age, job stability and time at current address or by using open banking to establish that the customer has a record of regular rent and utility payments. Some lenders avoid these types of customers due to the difficultly in accurately assessing the risk they represent[12].

In practice, each lender has their own view as to the definition of the different risk categories that are appropriate for their business model, which of these are acceptable groups to lend to and the measures (such as arrears and/or default rates) to use to measure them. However, many organisations adopt a similar view to the one presented here.

7.2 Score based grades

A more sophisticated approach that can be used in conjunction with or instead of rule based grading is credit scoring. The credit score is a single number that represents a weighted view of a customer's credit risk. This takes in account all relevant information that is known about them – which can run to hundreds of individual data items.

Typically, this includes geodemographic information such as their age, income, employment status and so on, as well as details of their past borrowing detailed on a credit report provided by a Credit Reference Agency.

Many credit scores range from 0 to about 1,000. Standard industry practice is that a low score means someone is very high risk, and a high score that they are a very low credit risk. In effect, each score is a very fine grade representing reducing risk as the score increases.

In deciding how to treat a customer based on their credit score, a lender will undertake analysis of large samples of historic loan agreements to examine the relationship between the score and eventual

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[12] This is more the case for organisations that don't fully utilize open banking.

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arrears/default. Each lender then defines accept/decline rules based on the score (grade) that correspond to the lender's risk appetite.

For example, a lender may decide that their risk appetite equates to an average default rate of no more than 5%. Analysis of historic data shows that cases scoring above say, 700 have default rates below 5% while those scoring below 700 have defaults higher than 5%. Consequently, the decision rule used by the lender is to only accept applications from customers with a credit score above 700.

Similar, but more advanced approaches will look at overall returns (Net Present Value or NPV) of loans by score and base cut-offs on break even or minimal acceptable returns.