Evolution not revolution

Solving IFRS 9 Impairment

Now, things are different

The last few years have changed things in risk. The regulatory environment we now operate in presents huge resource and skills challenges.

We make sense of now.

Contents

Section One

Introduction

Welcome to our whitepaper 'Solving IFRS 9 Impairment', written by our resident IFRS 9 experts Ben O'Brien, Risk Practice Director, and Nevan McBride, IFRS 9 Consultant.

This whitepaper provides a broad outline of the IFRS 9 regulations and details how financial institutions can comply with the requirements on impairment.

IFRS 9 comes in to effect on 1st January 2018 and, as of yet, it seems that no UK lending organisations have fully implemented IFRS 9 models. At the time of putting this paper together, most organisations, including several of our clients, are still in the early stages of preparation. As such, we have written this whitepaper using experience gained over several years of forecasting expected credit losses and guiding clients through regulatory change.

We hope you find this whitepaper useful. If you have any questions or would like to talk through what the regulation change means for you, call us on **0333 370 6600** or email us at **risk@jaywing.com**.

Section Two

About the authors

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Ben is an expert in credit risk management, providing analytical consultancy to clients in financial services, telecoms and utilities. With over 18 years' experience, his expertise spans credit scoring, loss forecasting and stress testing, provisioning, portfolio monitoring, value modelling and the analytical components of capital management. As well as deep subject matter expertise, Ben has a natural talent for communicating complex information with clarity.

Ben runs the Consulting Risk Practice at Jaywing and since joining in 2001 has led analytics teams for a number of clients in the UK, Europe and Australia, including a variety of substantial engagements in the UK banking sector.

Prior to Jaywing, he was a consultant at Experian, where he started out developing the Delphi suite of risk models. Later, he implemented credit risk models and systems to a diverse client base, including the introduction of credit scoring methods to the building society sector.

Nevan is a risk modelling and analysis specialist with over 12 years' experience, acquired with major financial institutions and consultancies such as Equifax, first direct, Bradford & Bingley, Morgan Stanley and HBOS. At Jaywing he is lead consultant on a broad range of credit risk analytical and modelling projects across a number of financial services clients.

In addition to his strong analytical and modelling skills, Nevan has a highly developed understanding of business issues across the entire risk spectrum. He has supported start-up clients to develop credit risk policies and strategies and has consulted for long-established big banks on matters including regulatory change.

Recently, Nevan has been applying his technical skills in critical business contexts, including in the leadership of the validation of a key client's Basel model suite and in his role of IFRS 9 Retail Risk Principle Liaison at a major high street building society.

Section Three

A background to IFRS 9

IFRS 9 was born out of the recent financial crisis and the desire to address the perceived deficiencies in the incumbent loss accounting legislation that delayed recognition of credit losses. These new regulations will replace the current IAS 39 regime and apply to all lending organisations.

"The move to ECL accounting frameworks by accounting standard setters shifts the banking industry forward in resolving the weakness identified during the financial crisis that credit loss recognition was too little, too late."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

IAS 39 was introduced to give financial institutions a unified and prescribed way of reporting financial instruments. In fact, inconsistent application of the standards made it difficult to compare financial results between entities.

IAS 39 is an 'incurred loss' model that was introduced to replace UK GAAP. UK GAAP did not allow for a general provision, and this left an opportunity for provision smoothing that IAS 39 looked to address, amongst its wider objectives. The general provision was in place, alongside specific provisions for delinquent accounts, to allow for future losses from up-to-date customers. IAS 39 delayed the recognition of credit losses until an actual trigger event, such as a default on a loan, was identified.

This delay in the recognition of credit losses was highlighted by the financial crisis as provisions for bad debt rose following a significant time lag. As a result, IFRS 9 has been designed to provide a logical, consistent classification and measurement approach for financial assets.

A major difference in the two standards is that IFRS 9 demands lending organisations implement a forward-looking expected credit loss model. With the new regime, losses will be recognised in a more timely manner and all lending organisations that are subject to impairment accounting will be subject to a prescribed model framework. This is intended to improve the stability of institutions and the financial system as a whole due to better loss forecasting, which will help institutions manage risk more effectively.

The Standard also looks to improve hedge accounting by better linking the economics of risk management with its accounting treatment. We've not covered this element of the IFRS 9 regulation in this document and have focused on the requirements around Impairment.

"While IFRS 9's mandatory effective date of 1 January 2018 may seem a long way off, we strongly suggest that companies should start evaluating the impact of the new Standard now. As well as the impact on reported results, many businesses will need to collect and analyse additional data and implement changes to systems."

Andrew Watchman
Global Head, IFRS

Section Four

What the regulations say

The IFRS 9 regulations have three main sections: Classification and Measurement, Impairment and Hedge Accounting.

1. Classification and Measurement Classification of assets into: Amortised Cost, Fair Value through Profit and Loss and Fair Value through Other Comprehensive Income

2. Impairment

IAS 39	IFRS 9
Incurred Losses for non-performing assets	Forward looking view of Expected Losses across all assets Two key modelling components: **1. Stage Allocation** • Driven by significant deterioration in credit risk • Impairment • Arrears, low risk **2. Lifetime Expected Loss** • Behavioural maturity • Economic forecasting
← **Retrospective**	**Forward Looking** →

3. Hedge Accounting
New general (micro) hedge accounting rules similar to IAS 39

Classification and Measurement splits assets into Amortised Cost, Fair Value through Profit and Loss, and Fair Value through Other Comprehensive Income. The classification of financial assets determines how they are accounted for in financial statements and, in particular, how they are measured on an ongoing basis.

IFRS 9 also incorporates new requirements that represent a major overhaul of hedge accounting rules. The new requirements introduce significant improvement by aligning the accounting more closely with risk management.

Arguably, the most significant change that IFRS 9 introduces is the change to Impairment Accounting, which ushers in a forward-looking approach to forecasting expected loss.

It also removes the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger event to have occurred before losses are recognised.

The new impairment model requires all lending organisations to recognise future expected credit losses and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

The requirements of IFRS 9 broaden the information that a company is required to consider when determining its expectations of credit losses. Specifically, IFRS 9 requires the company to base its measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information. The ability to meet the IFRS 9 requirements efficiently relies on the skills and experience of the credit risk modelling team that is assigned to the task.

This new forward-looking impairment model is accompanied by the increased disclosure of expected credit losses and credit risk. Lending organisations are now required to provide an explanation of the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk.

Another major change IFRS 9 introduces is that lifetime expected credit losses need to be recognised where there are significant increases in credit risk since initial recognition. This is to identify changes in economic loss expectations that are over and above the expectations at the initial assessment of risk, i.e. the expectation that set the original pricing.

It is the measuring of expected credit losses over the lifetime of the account that makes the implementation of IFRS 9 a challenge. The regulations don't prescribe a particular measurement method and there are various data sources, both internal and external, that can be used to build the models. However, knowing what data sources to use and how to build the impairment model takes specialist knowledge and expertise.

Even though measuring lifetime expected loss under IFRS 9 is a new challenge for organisations, the tools for forecasting losses over extended periods under different economic conditions are likely to exist already within risk and finance teams through their work on business planning and stress testing. It's a matter of knowing how to apply this knowledge to IFRS 9.

"Lifetime expected credit losses are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight."

IFRS Project Summary
'IFRS 9 Financial Instruments', July 2014

Section Five

10 steps to success

There are many factors to consider when implementing the new IFRS 9 requirements. To help, we've developed a 10-step process.

1	Interpretation of the Standards and Guidance
2	Current State Assessment
3	Historical Data and Existing Model Review
4	Methodology Development
5	Prototype Modelling and Initial Impact Assessment
6	Methodology Refinement
7	Final Modelling
8	Model Governance
9	Implementation and Testing
10	Model Monitoring

"The use of common processes, systems, tools and data strengthens, to the maximum extent possible, the consistency of the resulting estimates and minimises disincentives to following sound credit risk practices for all purposes."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

1. Interpretation of the Standards and Guidance

Lending organisations must formulate a collective interpretation of the IFRS 9 standards across Finance and Risk departments. There is some guidance from GAECL (Guidance on Accounting for Expected Credit Losses - formerly SCRAVL), which offers useful insight into the deeper implications of the regulation. The required collaboration across functions provides a challenging aspect to the project but strong ties between the risk and finance worlds is essential given the wide reach of the new IFRS 9 regulations.

After the standards have been interpreted, the next step is to establish a set of requirements for your organisation.

Many of these requirements can be addressed by harnessing tools already available within your current infrastructures, although there is likely to be a number of gaps that need filling before a fully compliant solution can be produced. By measuring the requirements against existing capabilities, a comprehensive list of gaps can be identified. This list will help demonstrate an understanding of the requirements of the standards on the business as well as provide strong foundations for the remainder of the project.

2. Current State Assessment

The many references to using existing credit risk tools make it imperative to conduct a thorough examination of your organisation's data, system and model infrastructure for suitability under IFRS 9 as a first step.

Important steps in conforming to the standards should be taken on:

i. Historical Data - to gain an understanding of the implications for your historical data and reporting systems

ii. Use of Existing Risk Models - to understand how the existing risk models suite can be leveraged to solve IFRS 9.

3a Historical Data Assessment

A thorough assessment of the data infrastructure, early in the project, will pinpoint any shortfalls in the capture, storage or processing of data essential for IFRS 9. This allows sufficient time to engage the wider business to organise and implement the necessary changes.

Data quality should be high on the list of priorities as quality of input data is one of the largest single factors in the ultimate quality of a model.

Given that stage allocation requires measuring change in credit risk from origination, data gaps or inconsistencies may exist for assets under different capital treatment. It also raises questions on how far back historically, and with what level of assurance, does origination data span? An audit of all the data items will be an important component of IFRS 9 and may uncover issues that result in a wider project to enhance data infrastructures as part of a longer-term vision for your organisation.

3b Existing Risk Model Review

Organisations with IRB status have models that calculate one year expected loss and will have the IRB models as a core component of the IFRS 9 model suite. Organisations without IRB will need to leverage existing risk models or build new models to forecast expected loss over one year and lifetime horizons. The models must undergo a suitability assessment to ensure definitions or assumptions made during the model development are compatible with IFRS 9. Examples of potential discrepancies are on the 'days past due' definition of default and the inherent conservatism built in to IRB models. During an IRB development, when a data or system deficiency is encountered and a set of remedial options are presented, the option that incorporates a level of conservatism is often selected. As IFRS 9 requires best estimates of expected losses, the scale of conservatism within the IRB models needs to be quantified, in the current state assessment, and removed, before implementation into IFRS 9.

Stress testing and loss forecasting models are already designed to predict credit losses, over long horizons, and under a variety of economic circumstances. Long-term forward-looking forecasts of expected loss is exactly what IFRS 9 is looking to promote. So it makes sense to align the processes and use stress testing and loss forecasting outputs to drive IFRS 9 lifetime expected loss.

Credit loss forecasting models have significant methodological differences from other credit risk models. Proficient models maximise the robustness of long-term estimates rather than purely optimising risk segmentation. Given that a forward-looking five-year view is all but equivalent to lifetime expected, then forecasting, stress testing and IFRS 9 processes should be aligned, underpinned by the same models that predict expected credit losses over time in other functions of the business.

So it makes sense to align the processes and use stress testing and loss forecasting outputs to drive IFRS 9 lifetime expected loss.

Inadequate credit risk policies and procedures may lead to inappropriate and untimely recognition and measurement of increases in credit risk.

4. Methodology Development

A natural next step from identifying the gaps between requirements and capabilities is to identify ways of addressing these gaps. There may be a single methodology or, more likely, an organisation will need multiple methodologies across different asset classes or portfolio segments. What is important is finding the right methodology to suit your organisation – there is no 'one size fits all' solution. Existing methodologies may not wholly solve the problem so exploring alternative methodologies is important. Clearly documenting the rationale behind methodology selection helps from an audit perspective.

5. Prototype Modelling and Initial Impact Assessment

Once methodologies have been identified, your organisation will be in a position to begin testing them. Until methodologies are selected, a full-blown modelling project may not be the most efficient course of action. Building prototype models will enable the pros and cons of multiple methodologies to be identified in a manageable time frame. In many model developments, particularly with new methodologies, there are likely to be unexpected challenges so this approach helps highlight any issues and facilitates remediation prior to starting the full model development process. This approach also helps approximate the model framework required for an end-to-end solution and is vital information for planning for the implementation and testing.

Another advantage of building prototype models early in the process is that they provide early estimates of the provision figures under the new regime. It is expected that provision cover will generally increase under IFRS 9 but getting an early view of the magnitude will help manage expectations with Executives and plan better for full implementation in 2018.

6. Methodology Refinement

A review of the figures from the Prototype Modelling and Initial Impact Assessment stage may uncover issues with Provision adequacy or stability. These issues can often be addressed by revising the modelling approach and so it's important to have the opportunity to refine the model methodology. If multiple methods are being researched, a quantitative and qualitative assessment will facilitate the selection of the optimal method for the business. These actions provide a good foundation before moving into the critical final modelling stage of the wider project.

7. Final Modelling

Once the current infrastructure has been assessed for suitability and methodologies selected, the final modelling can begin. All modelling should adhere to already established standards with sound model validation to ensure they are robust, predictive and relevant. The data inputs must prove to be representative of the portfolio prior to commencing any development. It is widely touted that adherence to IFRS 9 will result in a suite of models across multiple portfolios but, in our view, planning and preparation is key to avoiding over-engineering the solution and leaving a model legacy that is difficult to maintain. Project plans must be established and met to enable stakeholders across the business to contribute to model approval and facilitate an efficient governance and oversight process. It's important to remember that modelling is one of the core components of the project and keeping records of the model development processes that have been followed is critical to developing a fully compliant solution that concludes with audit and Prudential Regulation Authority (PRA) approval.

To ensure acceptable performance during validation, include the level of acceptable discriminatory power, stress testing thresholds, backtesting thresholds and any other relevant validation standards.

8. Model Governance

Given the scrutiny from the PRA and auditors, it's fundamental to a successful process that the final models go through appropriate independent validation and challenge. As ever, comprehensive, quality model documentation is critical to demonstrating compliance. The documentation should include information around the methodologies employed and judgements made throughout the process as well as describe the model development journey in the agreed model documentation format. The regulators will view the model documentation as evidence of compliance to the IFRS 9 Standards, so investing time in producing high quality documentation is paramount.

Much has been made of the role of model governance generally, and this factor was specifically highlighted in the announcement last December of the results of the first of the Bank of England's concurrent stress tests. It is essential that appropriate independent validation of the modelling approach is obtained during the course of the development process.

9. Implementation and Testing

Development and approval of the models is by no means the end of the journey. The models must be implemented onto your systems and run in parallel alongside IAS 39 models for at least one year. This lengthy time frame acts as proof that the models are implemented correctly and allows the organisation to demonstrate adequacy and stability in the provision estimates. At this stage, the structure of the financial reports should be agreed and the means to populate these reports automatically from the model estimates developed.

10. Model Monitoring

Demonstrating that the models are predictive and stable at development is only the first step in validation of the lifespan of a model. The models must be monitored regularly to ensure they remain fit for purpose. Monitoring lifetime expected loss models comes with its own challenges; these complexities should be considered early in the development of the models. Ensuring a monitoring framework is in place means that models continue to be assessed for compliance to IFRS 9 and to internal validation standards.

"A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring the appropriate level of credit risk on all lending exposures."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

"A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

Section Six

Compliance through evolution not revolution

While the requirement to assess lifetime expected losses may present a significant challenge, it is expected that many lending organisations have the broad foundations in place on which to build a fully compliant solution.

Loss Forecasting Toolkit

IFRS 9 Provision	
IRB Models	Loss Forecasting Engine
Regulatory Capital	Stress Testing

Rather than building an IFRS 9 solution from the ground up, incurring significant cost and demands on resource, it is possible, and desirable, to take a more pragmatic approach that uses existing tools and processes.

IFRS 9 provisions should not be independent of other risk and loss measures within your organisation. A strong IFRS 9 framework leverages the IRB model suite, regulatory capital models and the loss forecasting and stress testing processes to provide a forward-looking assessment of expected loss that is aligned to business planning and stress testing outcomes.

After all, predicting losses over the lifetime of an account under various economic circumstances is very closely aligned to predicting losses over five years under base and stress economic environments, as you do in stress testing. As such, your IFRS 9 provisions need to align closely with your stress testing and loss forecasting submissions.

Section Seven

Stage allocation

One of the most important components of the Impairment calculation under IFRS 9 is the allocation of assets into pre-defined stages. Ultimately, these stages define the horizon over which the expected losses are calculated.

Stage 1	Stage 2	Stage 3
• No change to credit risk outlook or 'low-risk' • Calculate expected loss over 12 months • Calculate income excluding potential losses (gross)	• Credit risk outlook has worsened • Calculate expected loss over the lifetime of the account • Calculate income excluding potential losses (gross)	• Account is impaired • Calculate expected loss over the lifetime of the account • Calculate income including potential losses (net)

A number of credit risk indicators have been identified within the standards or the GAECL guidance as potential stage allocation factors.

A backstop of 30 days in arrears must be applied, at a minimum, to assign an asset to Stage 2. However, the purpose of the staging model is to anticipate any movement into delinquency prior to the event. It is now understood that the application of 'low risk' may be difficult, especially as industry benchmarks are difficult to agree.

The standards state that "significant increase in credit risk from initial recognition" must also incorporate forward-looking components. This suggests lifetime models should be deployed across all assets at the point of origination. This presents complexities and could impact the accuracy and stability of stage allocation unless considered carefully.

One of the main observations about the stage allocation requirements is the influence this model will have on the stability of provisions. While provision accuracy and adequacy are of primary concern, the consistency of the estimates over time is also important. The logic underpinning asset transfer between stages will influence stability.

Assets must immediately transfer to Stage 2 when the criteria is met, however, GAECL suggests prudence should be applied within the transfers back to Stage 1. This could disturb symmetry and disrupt the stability of provisions unless an appropriate balance is achieved. Mitigating volatility is a further consideration during the development of these models and so appropriate validation tests should be conducted for assurance.

Section Eight

Modelling lifetime expected loss

Modelling lifetime expected losses is probably the most complicated and therefore topical aspect of IFRS 9.

The remaining life of the exposure should be carefully determined and should take account of expected prepayments.

The determination of losses across the lifetime of an asset presents considerable challenges.

This is especially true given the requirement to incorporate a forward-looking view and the fact that estimates tend to become less accurate the further forward you forecast.

"Expected credit losses shall be measured to reflect:

1. An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

2. The time value of money;

3. Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions."

IFRS 9 (B5.5.17)

The expected loss calculation technique that is currently favoured in the industry is the marginal expected loss approach. There are a number of components within this calculation approach:

Project PD, EAD and LGD
IRB models can be used as a starting position for lifetime expected losses but these estimates are twelve month forecasts and so must be projected forward to gain a view of Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD) beyond one year.

The following points should be considered as inputs into your projections:

Economic Forecasting
The requirement for a forward-looking view suggests that economic forecasts should be overlaid into the projected PDs, EADs and LGDs. These forecasts must be aligned to your organisation's view of future economic events and should consider a number of different economic scenarios to provide appropriately probability-weighted distributions of credit losses.

Prepayment/Amortisation
Prepayment describes the event of a loan being paid off prior to reaching the full term. Amortisation is the natural reduction of a loan balance as it is repaid according to the term of the loan. Both these phenomena will directly impact your models and will interact with your economic forecasts. Modelling both prepayment and amortisation flows will become more important within your organisation.

Undrawn Commitments
Undrawn commitments will also feed into EAD projections and are influenced by economic forecasts for revolving credit products. The forward-looking requirement means the possibility of obtaining additional credit must be included.

Maturity

After obtaining projections of PD, EAD and LGD, the horizon over which they are applied must be derived. This maturity estimation could be driven by the term of the loan, although that will not be available for revolving products. Maturity could be modelled using factors such as product type, age (or term remaining), delinquency status and economic forecasts.
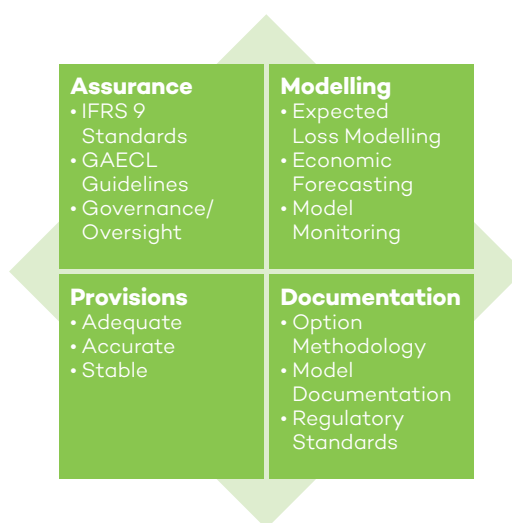
Discounting

The time value of money must be taken into account by discounting expected losses using original Effective Interest Rate (EIR). This may not be available for all assets; if so a suitable proxy must be derived.

The sheer number of requirements, as outlined above, may be initially daunting given the required resource investment. However, we believe that existing tools and methodologies can be harnessed to fulfil these requirements. Instead of creating new, complicated modelling and data architectures, we promote extending current forecasting and stress testing frameworks to determine lifetime expected loss. This also helps bring forecasting, provisioning and stress testing closer together, which complements the standards as well as creating synergies, resource efficiencies and clear consistency benefits.

One forecasting methodology that lends itself to IFRS 9 is EMV (Exogenous Maturity Vintage) modelling because of the way it combines economic and lifetime factors.

The approach uses a dynamic delinquency data structure to separate portfolio trends into exogenous, maturity and vintage components.

These components can then be combined with supplementary factors to drive expected loss over a lifetime of the account aligned to loss forecasting and stress testing outcomes.

Assurance
- IFRS 9 Standards
- GAECL Guidelines
- Governance/ Oversight

Modelling
- Expected Loss Modelling
- Economic Forecasting
- Model Monitoring

Provisions
- Adequate
- Accurate
- Stable

Documentation
- Option Methodology
- Model Documentation
- Regulatory Standards

Exogenous Maturity Vintage Modelling

Time on Book ▶

Vintage ▼

Dynamic Delinquency Data

Modelling Engine

Vintage	Maturity	Exogenous

| 2007 ➝ 2013 | 3 ➝ 72 | 2007 ➝ 2013 |

Lifetime Expected Loss (portfolio) ◀ **Economic Assumptions**

LEL (Individual 1)	LEL (Individual 2)	LEL (Individual 3)

Section Nine

Challenges and risks

In order to implement the requirements successfully, there are a number of additional challenges.

The models should be developed, validated, implemented and tested by the end of 2016.

1. Timescales

The mandatory effective date for calculating provisions under the new IFRS 9 standards is 1st January 2018. The distance between now and then may provide some comfort; however, the tasks ahead are complex and are likely to prove time-consuming.

The new provision figures under IFRS 9 must be corroborated, by running them in parallel for at least one year alongside the current IAS 39 provisions. Consequently, the models should be developed, validated, implemented and tested by the end of 2016.

The model development work required must not be underestimated. Your modelling team may be highly skilled, with many years of experience, but it is likely that the IFRS 9 forecasting methodologies will be novel. The requisite learning process, coupled with the sheer amount of development needed to produce a robust IFRS 9 framework, means that the project needs to start early to meet the deadline.

2. Resources

All credit risk functions will suffer from under-resourcing at some stage. The extra burdens placed on an organisation due to the recent increase in regulatory rigour exacerbate the problem. The requirements of IFRS 9 will mean an increase in workload in Risk and other departments including (but not limited to) Finance, IT and Economic/Corporate Development. Understanding the level of involvement required by these different areas is fundamental to proper resource planning.

The most resource-heavy elements of your IFRS 9 project will be the modelling and evaluation of results. These are both areas that need experts; and while investment in technology can sometimes help reduce delivery times, having the right people, knowledge and processes is essential.

This will undoubtedly comprise a team of experienced model builders, analytical consultants and data management specialists, all of whom must be up to date with the IFRS 9 standards, GAECL guidance and analytical techniques. Many financial institutions are currently assessing the various options, from recruiting to outsourcing - each of which has its relative costs and benefits.

3. Regulatory uncertainty

Some aspects of the new standards are still unclear and untested in terms of how they should be interpreted. Not all organisations will formulate the same interpretations and, hence, slightly different approaches will naturally establish themselves throughout the industry. This same situation developed when the Basel Accord rules were published, so it is important to carry the lessons learned from this into the IFRS 9 process.

Basel II compliance was greatly assisted by working closely with the regulator, in its supervisory role. As rules were being clarified over time, having sight of models across the industry allowed the regulator to influence direction so that interpretations of the guidelines had a certain degree of consistency.

This did not take the form of official guidance; rather, it was the result of probing questions from experienced people who kept abreast of the emerging best practice. In this way, the development and application of the various Basel models (and the quality and scope of relevant documentation) were guided in the right direction.

One clear parallel between IFRS 9 and Basel II is the link between the Risk and Finance worlds. The application of Lifetime Expected Loss will fall firmly in Finance. However, Finance and Credit Risk are quite different disciplines; Risk practitioners know all the pitfalls and quirks of measuring Expected Loss accurately and can recognise when important steps have been missed and when models fail to address key aspects of a business and its data. Therefore, Finance disciplines are important to embed the new rules in an organisation's accounting practices and culture; whereas Risk professionals are needed to ensure that Expected Loss models are both realistic and effective. Having been through the rigours of Basel II Waiver applications, Risk teams understand how to construct a solution effectively and will not start the project as if it is simply a question of following a set of fixed, simple and step-by-step rules.

4. Engagement with the wider business
The IFRS 9 standards will require a unified interpretation across your Risk, Finance and Economics teams. These teams will have varying degrees of specialist knowledge, and different levels of input and resources will be required for the implementation of an IFRS 9 project.

Risk and Finance teams are likely to be sub-divided by asset type: Retail, Corporate and Treasury. For each different product, there will be different subject matter experts and varying levels of sophistication in terms of the existing data and modelling infrastructure.

This can cause problems as the different areas have their own priorities and goals.

The standards frequently state the need for businesses to maintain consistency wherever possible; this means the different areas should join forces as early as possible and agree on an all-encompassing plan that fits everyone's needs. These rare collaborations can prove difficult as, typically, different terminology is used across these different fields. It is important to achieve common ground and agree upon the interpretations to help move the project forward.

5. Governance
The governance process is expected to be especially challenging, due to the significance of IFRS 9, the complex and innovative technical modelling and the wide reach within each business. The sheer scale of IFRS 9 will mean that the output of the interpretation exercise will consist of a multitude of decisions. These decisions will have varying degrees of significance to your organisation and will provoke internal discussion and debate. Approval will then be required from lower level managers right up to executive level.

The planning behind Governance will need to be a priority because of its significance within the project. The availability of stakeholders can often delay decisions that will impact already tight project time frames. Appropriate documentation must support the decisions, with discussions and approval recorded to ensure that a comprehensive audit trail is kept.

"An effective internal control system should contain clear formal communication and coordination among a bank's credit risk staff, financial reporting staff, senior management, the board and others."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

"Banks should establish an overarching governance framework over the model validation process."

Basel Committee on Banking Supervision Consultative Document 'Guidance on accounting for expected credit losses', February 2015

Section Ten

In conclusion

While 2018 may seem quite a long way off, there is a lot of work to be done in order to meet the new requirements on time.

This means being up and running under IFRS 9 from 1st January 2017.

The consequences of sub-standard models or over-engineered model architectures are likely to be significant.

In addition, it is important to recognise that the provision figures under IFRS 9 must run in parallel for at least one year, alongside the current IAS 39 provisions. This means being up and running under IFRS 9 from 1st January 2017.

Those who start now to work towards implementation stand themselves in good stead to meet the requirements on time but also to establish a robust and efficient framework that leverages existing tools. Taking this approach and starting work now will leave Risk and Finance functions with a well thought out IFRS 9 infrastructure that will be straight-forward to manage in future.

Implementing the new regime poses some interesting challenges for lending organisations, three of the biggest being: modelling lifetime expected loss; stage allocation; and the data and model architectures needed to deliver all requirements. These elements are fundamental to meeting the requirements laid out by the regulators and must be done with rigour, accuracy and expertise.

As with all step changes, it requires a considerable shift in the effort required. This of course means that resource demands for the new requirements are likely to be high, not just for the initial implementation but for the ongoing monitoring and development of loss forecasting models.

The key to success is to minimise the impact on your 'business as usual' teams. This can be achieved most readily by looking at what systems and capabilities currently exist within an organisation and

what additional support and expertise may be at your disposal externally.

By outsourcing some or all of the stages of the project, you can ensure that the regulator's demands and timescales can be met, while at the same time helping your internal teams learn from the expertise of those who have implemented similar processes before.

When choosing an external partner to work with, make sure any consultants you engage are fully aware of the requirements and can demonstrate solid experience in preparing data and building lifetime expected loss models. The consequences of sub-standard models or over-engineered model architectures are likely to be significant, both in terms of holding excess provisions and in having unwieldy processes that will be difficult to manage going forward.

The correct implementation of the requirements under IFRS 9 requires data specialists and modellers who have direct experience and a deep understanding of forward-looking loss forecasting.

Although the task at hand may seem daunting, Jaywing's credit risk modelling experts are well versed in building, validating and monitoring the models required under the new requirements.

So, even though your organisation may not have the luxury of time, there is a large team at Jaywing that can help you meet these new requirements by the deadline set by the regulator, while giving your own people the opportunity to learn from those who are experienced and skilled in forecasting expected loss.

Section Eleven

About Jaywing

We're a business full of talented individuals who connect powerful ideas, rich data and new technologies to make sense of now.

The regulatory environment we now operate in presents huge resource and skills challenges. We've been forecasting expected credit losses for a range of UK lenders and have a proven track record of helping clients deliver regulatory change programmes. For over 16 years, we've been firmly established as of one of the leading practitioners of loss forecasting services in the UK.

We believe that we have the best team of analytical credit risk professionals in the UK, and that's not something we say lightly. We are renowned for the strength of our skills in data, modelling and analysis; skills that underpin all of the roles needed for successful IFRS 9 implementation.

Our Experience in Regulatory Change
Upon the introduction of the Basel Accords, we worked closely with the banking sector to model aspects of expected loss. As a result, we quickly became experts in Probability of Default, Exposure at Default and Loss Given Default modelling. However, these were not new skills for Jaywing but rather a different application of the same credit risk modelling skills upon which the team was founded.

Our team has also helped major UK financial institutions transition from the UK GAAP provisioning to the IAS 39 incurred loss methodology.
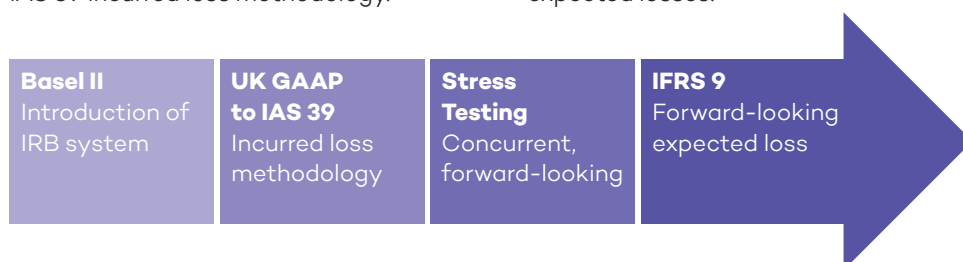
During this time, we often acted as the client's in-house credit risk modelling team and worked closely with the client's auditors. We now draw upon this experience to help our clients with the next phase of that transition - moving from IAS 39 to IFRS 9. We have a strong reputation in regulatory risk and are known to the regulators for our excellence in risk, data and modelling. We are currently working with several leading UK banks on IFRS 9 modelling projects.

Our Approach to Loss Forecasting
Our established approach to loss forecasting has been developed over 16 years. Our methodology has been used successfully across many UK lending organisations as a principal forecast, as well as a challenge to a bank's own forecast.

Since 2008, the regulatory agenda has changed continually, with the forthcoming changes focused on introducing leverage ratio requirements and changes to loss provisioning under IFRS 9, as well as introducing the new concurrent stress testing regime.

Today, our consultants couple their regulatory knowledge with their long-held expertise in provisioning, loss forecasting, capital management and stress testing to help clients address the most challenging aspect of IFRS 9 – modelling lifetime expected losses.

Basel II Introduction of IRB system	**UK GAAP to IAS 39** Incurred loss methodology	**Stress Testing** Concurrent, forward-looking	**IFRS 9** Forward-looking expected loss

Section Twelve

Contacts

Why not invite us in for a chat and we can give you the inside story on what IFRS 9 will mean for your business.

We can help you learn about the changes in bad debt provisioning, the demands it will place on your organisation and what you can do now to make sure that you will be able to comply.

Call us on **0333 370 6600** or email us at **risk@jaywing.com**

Notes

JAYWING