SEVEN RISK PREDICTIONS FOR 2018

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The last few years have seen a significant increase in regulation with the overall intention of protecting banks, consumers and global economies against economic downturns and other major risks such as cybercrime.

Many firms are looking at advances in analytics and technology to help manage this influx to allow them to go back to focussing on the most important aspect of any business: profitability.

Will 2018 be the year that Artificial Intelligence finally takes a hold in the banking industry? We think it will, and when it does, it will revolutionise risk in banking and beyond.

Here's 7 risk trends that we predict for 2018.

2018 TO MARK YEAR ONE FOR MANY LENDERS EMBARKING ON THE IRB JOURNEY

The last couple of years have seen significant changes to the regulation underpinning how banks set their capital requirements, particularly in an Internal Ratings Based (IRB) world.

Last year ended with announcements from the Basel Committee on Banking Supervision (BCBS) of reforms which are likely to increase capital requirements for lenders on the Standardised approach particularly those lending in the higher LTV market or with material concentrations of Income Producing Real Estate.

These lenders are already looking at the IRB approach as a means of consuming proportionately less capital with a high likelihood of being in a better capital position even before the application of the BCBS reforms.

The transition to IRB for smaller organisations was never a consideration due to the associated complexity and cost but it is now in reach more than ever.

Last year the PRA implemented regulatory changes removing some cost and data barriers to entry, enabling smaller lenders to reap the benefits.

For many organisations embarking on the IRB journey, 2018 marks the mobilisation of their programme. IRB will elevate the status of your firm with investors and regulators alike as it promotes robust risk management frameworks and improves capital efficiency. But for many, this requires an investment in resources such as data, technology and modelling expertise.

With reforms often requiring significant business change, lenders should start to prepare for IRB compliance now to meet the 2022 BCBS reform date.

Artificial Intelligence is big news. Every day generates a newsworthy advance – in self-driving cars, even smarter phones, self-learning thermostats. In healthcare, AI is transforming tumour identification, delivering better detection results than experienced oncologists.

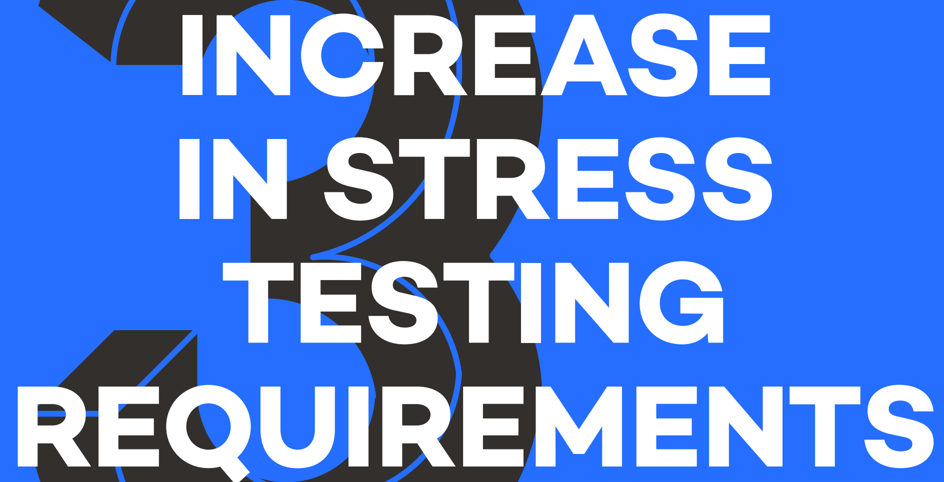
So far, the credit industry has been slow to adopt. But many companies are exploring what AI means for them, and the regulators are watching with interest.

Advances in computing power and deep learning techniques mean it's now possible to make use of Artificial Intelligence to squeeze more value out of predictive data. Now that AI is also capable of generating transparent, explainable models that can follow business rules, the regulatory hurdles to adoption are finally being met.

AI stands ready to revolutionise the way that credit scoring is undertaken: better, faster models, more regularly updated, with the business in control.

With an eye on Open Banking, the availability of more data makes it imperative that lenders take a look at this trend in 2018.

ARTIFICIAL INTELLIGENCE (AI) TO REVOLUTIONISE CREDIT SCORING



INCREASE IN STRESS TESTING REQUIREMENTS

The seven largest UK banking organisations have been participating in the annual Bank of England Concurrent Stress Test now for 4 years. They are developing appropriate structures to meet more stringent stress testing requirements.

In 2018 with an increased focus on consumer indebtedness it is expected that smaller lenders will need to up their game and assess carefully the suitability of their current ICAAP framework.

Increased scrutiny will be placed by the regulators not only on modelling, but also on process and policies around stress testing, with particular attention to senior management and board members and the implications of stress testing for both strategic and capital planning.

For this reason financial institutions must engage in a careful planning and define clearly all the events that need to happen in a successful stress test or ICAAP. The ICAAP is, by definition, an internal process but organisations need to consider if they have the proper setup and resources needed to show the PRA they mean business and are not a risk to the future stability of the UK financial sector.

Open Banking will have a relatively slow start, but it has the potential to level the playing field between providers. This will result in a gradual shift towards new aggregated services and a marketplace of regulated providers who will offer appealing services to consumers based on their own banking data.

Interesting times lie ahead for lenders. Established players face a challenge from innovative organisations targeting their customers using their own data. Customers may get used to using third party intermediaries; increasingly, they will bypass the use of individual lenders' apps and websites, with the associated loss of marketing opportunities.

New providers will need to make best use of open data, but may face some modelling and assessment difficulties in the absence of outcome data. What does this mean for the traditional credit reference agency?

And let's not forget that we now operate in a GDPR-compliant world in which permission is everything. Providers must ensure that customer data is being handled appropriately; it must be clear to the consumer who is the custodian of their data.

With much to consider, financial services providers should be thinking now about the implications of linking GDPR permissions to Open Banking data and using this to drive innovative product developments of their own.

5 GROWTH AND DIVERGENCE OF FINANCIAL CRIME RISKS EXPECTED TO CONTINUE

In the last couple of years, the scale and complexity of cybercrime in particular has risen with too frequent announcements of banks who have fallen victim.

This growth has come about due to the increased digitisation of our daily lives, with many of us now paying our bills, managing our banking and paying our taxes online.

Whilst this digitisation brings many benefits both to individuals and businesses, it also brings increased levels of risk, with the financial services sector at particular risk of an evolving and fast-growing threat.

Many banks have made significant progress in their fight against cybercrime, with some having vast amounts of data collected from across their digital platforms, enabling them to have a much clearer viewpoint on who their customers are and their regular patterns of activity.

Some are even using real-time Artificial Intelligence (AI) techniques to spot suspicious activity, as a function of this explosion of data and the fact that many payments now take seconds, rather than the days previously taken to process.

Finally, the new Payment Services Directive (PSD2), tied with the UK's decision to adopt the Open Banking standard will result in the opening up of customer data to a significantly increased number of financial service providers.

This proliferation of activity and transactions across organisations increases both the potential risk of data security breaches and the likelihood that suspicious behaviour may go unnoticed, as each organisation will have a more limited view of their customers.

These factors, combined with the growing potential and usage of cryptocurrencies (using blockchain technologies, with their increased levels of customer anonymity), mean that the financial crime landscape will continue to grow increasingly more diverse and complex during 2018.

2018 is the deadline for IFRS 9 compliance and a milestone for lenders accounting under these new standards.

Most organisations will have their IFRS 9 framework fully embedded into their business practices following model development, validation, implementation, testing and execution.

For lenders of all sizes this is the culmination of a momentous amount of work so does this signal the end of IFRS 9?

Probably not.

Lenders may have more work to do to satisfy auditors. The audit at year-end may highlight model weaknesses, particularly those associated with the forward-looking requirements after sensitivity or benchmarking tests.

Auditors have shone the spotlight on the end-to-end process which may force lenders to revisit their data processes and system setups to improve controls and efficiency.

For some, IFRS 9 was badly timed with an agenda already packed with key projects and business goals. These lenders are likely to have taken a simplistic approach to safeguard compliance for this year with future plans to revisit.

2018 may be the beginning of the planning period for this 2nd generation of models by synergising with other programmes such as moving to IRB status.

Even if you've escaped the hazards outlined above, there will be more to do on IFRS 9 in 2018. The models must be monitored and validated to ensure they remain optimal and accurate and IFRS 9 provisions must be forecast and stressed for planning and ICAAP purposes.

Model refinements may be necessary as the approaches adopted to meet the complexity and novelty within the standards are understood better.

WILL 2018 BRING IFRS 9 TO ITS CONCLUSION?

7 GETTING BACK TO TRADITIONAL RISK – INCREASING PROFITABILITY

Over the last few years there has been increased focus on regulation within lending, driven by the financial crisis and an enhanced scrutiny on unexpected and expected losses.

As a result, banks are now better capitalised than ever but efforts previously focused on optimising customer and portfolio value have been diverted to address the increased regulatory burden.

Advancements in Artificial Intelligence (AI) and data science promise to revolutionise the way lenders operate. Better use of data and of mathematical approaches to solving business problems mean that lenders can adapt to new regulations and increase portfolio profitability simultaneously.

With IFRS 9 predicting losses over the lifetime of the customer, the time has now come to understand and optimise revenue.

ABOUT JAYWING

Jaywing's team of risk and data science specialists is now more than 70 strong and we have almost 20 years' experience helping many of the UK's lenders with data and analytics projects in risk and marketing.

Through our industry-leading expertise and trusted partnership approach, Jaywing has held many long-standing (10 years+), large-scale relationships with some of the UK's leading financial services organisations.

We have a wealth of experience in the financial services sector, working within both consumer and commercial portfolios, and our team of experts have developed industry leading ways of using data, analytics and systems to help our clients to manage credit and fraud risk to meet the ever-increasing regulatory demands.

Our expertise encompasses: banking regulation such as IFRS 9, Stress Testing, Capital Management and IRB; and risk strategy including operational decisions, pricing and collections optimisation.

We have recently added Artificial Intelligence to our skillsets and have a suite of machine learning and AI products to add to our existing risk product suite.

We have supported over 25 lenders in the UK with risk projects including Lloyds Banking Group, Royal Bank of Scotland, Nationwide, Secure Trust Bank, Shawbrook Bank, Paragon Bank and Coventry, Skipton, West Bromwich, Newcastle and Nottingham Building Societies.

About the Author

NEVAN MCBRIDE

Risk Practice Director

Nevan is the Director of the Risk Practice at Jaywing and is a data and analytics expert with almost 14 years' experience of credit risk in regulation and credit strategy, across the entire credit lifecycle in retail, SME and corporate lending.

Since he joined Jaywing over five years ago, Nevan has led and provided oversight for a number of large scale client projects including Royal Bank of Scotland, Nationwide, Shawbrook Bank and Secure Trust Bank.

He led the IFRS 9 proposition which has included advising on the design, development and implementation of IFRS 9 model frameworks and more recently, he is leading the IRB proposition.

Nevan's experience also includes almost five years working at a Credit Bureau helping clients to make better decisions using data driven analytics. This followed a number of years as a statistical modeller with experience of developing and validating IRB models and credit scorecards.

Nevan has a degree in applied mathematics and statistics.

Our new Artificial Intelligence (AI) powered risk modelling product.

Archetype solves the 'black box' problem which previously prevented the use of neural nets in credit risk.

Our patent applied for methodology is guaranteed to produce models that follow sensible rules like scorecards do - but produces much better results. This means they can be signed off through your usual governance process.

Call our risk specialists on 0333 370 6600 or email risk@jaywing.com

Where now?

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