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Validation of IFRS 9 models

A regular cycle of model validation is required, including monitoring of model performance, review of model quality and compliance with the standard

1 Model Development → 2 Initial Validation → 3 Approval → 4 Implementation → 5 Use in Business → 6 Periodic Validation

Validation has to be performed throughout the entire IFRS 9 model lifecycle to understand how the models **behave under different circumstances** and what the overriding effects are on the final provision numbers.

Validation techniques, such as **back testing**, will evaluate the performance of the models on historic data and enable to understand the volatility of the outputs against historic periods. In addition, running **'what-if' scenarios** helps to further validate the models on more extreme scenarios that have not necessarily been experienced within historic periods.

The key is to ensure whether models produce **provision estimates that are adequate, accurate and stable** and model validation is an exercise to assess, with a degree of confidence, that the models fulfil these criteria.

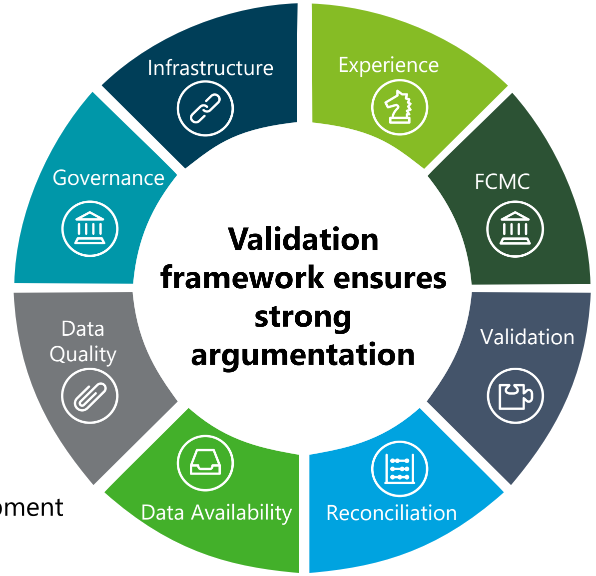
VALIDATION FRAMEWORK

Quantitative validation

- Life time PD; LGD; EAD
- Stage criteria
- Scenario probabilities
- Life time expected loss
- Maturities
- Prepayment
- Modification tool

Qualitative validation

- Model design
- Documentation
- Use in bank steering
- Review forward looking model development
- Data quality
- Review of the documentation



VALIDATION OF IFRS9 COMPONENTS

1 PD Validation
- Check stability of data used for modelling
- Assess the performance of extrapolation model for one year PDs and life time PDs
- Conduct calibration tests of model in order to assess the differences between estimated and realized defaults

2 CCF Validation
- Check stability of data used for modelling
- Assess the discriminatory power of the model
- Concentration test

3 LGD Validation
- Assess LGD based on default arising various vintages to understand consistency over time and extend of adjustments needed in the first place
- Assess the discriminatory power of the model
- Assess evidence of segment stability over time

4 Validation of staging approach
- Test the sensitivity of stage allocation to variation in the forward looking information
- Check the stage transfer process
- Assess the discriminatory power of qualitative factors used in staging

5 ECL validation
- Test the performance of selected segments, and alternative segmentation approaches
- Review of the methodology
- Review that ECL is discounted properly

6 Validation of the Macro-economic models
- Perform macro economic factors backtesting
- Assess differences between observed and estimated macro economic parameters

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OUR APPROACH

How can we help?

Deloitte's offering to your firm can include:

- Providing an exhaustive validation methodology;
- Assisting on required analyses and actions to identify early signals of model deterioration;
- Developing/Re-developing credit risk models used to generate lifetime PD, LGD, EAD;
- Providing a holistic solution for validation and benchmarking;
- Reviewing methodology and model specification, assumptions and design;
- Validating macro models used to generate scenarios and scenario probabilities.

DELOITTE VALUE SOLUTIONS

A market-tested methodology and deep understanding of IFRS 9

Organization
Centralized response team and communication, kick-off meetings and an action plan. Clear responsibilities and action plan.

Data and IT
Centralized data definition, data quality checks, samplings of portfolios, quantify impact of known challenges. Support in the preparation of data and process flows.

Governance and Processes
Review of key governance structures and processes to be compliant with regulatory requirements and ECB views on minimum requirements.

Deficiencies and Issue Management
Become aware of potential deficiencies by running preliminary health checks, use opportunity to understand past issues, anticipate issues and work on remedies and quantify impact.

OUR EXPERT TEAM AND QUALIFICATIONS

Experienced professionals
Senior professionals with broad-based and relevant experience in IFRS 9 modelling, audit and advisory

Global presence
Global resource and knowledge network: topic clarifications and refinements, training, benchmarking, exchange of technical questions and leading practices, support in all relevant jurisdictions

Andris Liepins
Director

Prior to joining Deloitte in 2016, Andris has acquired more than 7 year experience with Bloomberg Lp, London across broad spectrum of financial markets. Andris has worked with European banks, buy-side institutions and corporations on various topics ranging from implementation and assessment of risk management processes, transaction feasibility analysis, cash OTC and derivatives portfolio valuations, stress testing, drafting implementation strategy and supporting throughout implementation phase with respect to the new regulatory framework (e.g. EMIR, MIFID II, PRIIPS).

Rihards Zauers
Manager

Rihards Zauers is a Manager in the Financial Advisory department of Deloitte. Rihards is specializing in financial modelling, valuations and transaction support. Rihards has valued loan portfolios across Baltic states with cumulative value in excess 2BEUR

Prior to joining Deloitte, Rihards spent almost 4 years with Transaction advisory practice of another international professional services firm. Rihards has a Bachelor's degree in Economics and Business Administration from Stockholm School of Economics in Riga and is CFA charter holder.

Guna Kudrjavceva
Manager

Guna is a Manager in Risk Advisory department of Deloitte, with focus on Risk & Regulatory aspects of Financial Services industry.

Guna has more than 9 years of professional experience in Financial Services industry within private and public sectors. Guna has extensive experience in credit risk management, financial management, Financial Industry regulation compliance, regulatory and management reporting requirements.

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IFRS 9 models
...in light of COVID-19

EBA provides further assistance to banks and consumers in the application of the prudential framework in light of COVID-19

- EBA calls for flexibility and pragmatism in the application of the prudential framework and clarifies that, in case of debt moratoria, there is **no automatic classification** in **default**, **forborne**, or **IFRS9 status**.
- EBA, nonetheless, insists on the importance of adequate risk measurement and expects institutions **to prioritize individual assessments of obligors' likeliness to pay** when possible.
- **Consumer protection** remains a priority and financial institutions should ensure **full disclosure** and act in the interest of customers, with no hidden charges or automatic impact on credit ratings.

The European Securities and Markets Authority (ESMA) has issued a Public Statement on some accounting implications of the economic support and relief measures adopted by EU Member States in response to the COVID-19 outbreak

- Issuers should carefully assess the impact of the economic support and relief measures on recognized financial instruments and their conditions. This includes the assessment of whether such measures result in modification of the financial assets and whether modifications lead to their derecognition
- The measures taken in the context of the COVID-19 outbreak which permit, require or encourage suspension or delays in payments, should not be regarded as automatically having a one-to-one impact on the assessment of whether loans have suffered a SICR. Therefore, **a moratorium** under these circumstances **should not in itself be considered as an automatic trigger of SICR**.
- If reasonable and supportable information that is more forward-looking than information on the past due status of the concerned exposures is not available without undue cost or effort (either on an individual or a collective basis), **issuers may use past due information to determine whether there have been significant increases in credit risk** since initial recognition.
- When forbearance measures are provided to borrowers by issuers, these measures should be analyzed taking into account all the facts and circumstances, in order to distinguish, for example, whether the credit risk on the financial instrument has significantly increased or whether the borrower is only experiencing a temporary liquidity constraint and there has not been a significant increase in credit risk

Deloitte can help you...

- ...adjust current IFRS 9 implementation to include EBA and ESMA recommendations;
- ...reflect in the ECL the measures taken by the government to mitigate COVID-19 impact;
- ...identify viable customers and clients with temporary liquidity difficulties;
- ...analyze and reduce Pro-Cyclical Effects of Covid-19-Pandemic on ECL and Stage Allocation

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