

DIRECTED RISK RESEARCH PROBLEM STATEMENT

Risk Theme	Credit Risk	Problem Nr.	PS18001
-------------------	-------------	--------------------	---------

Client Name	Derek Doody	Client Org.	BAG
Designation	Head: Methodology		
E-mail	Derek.Doody@absa.co.za	Tel (w)	011 350 -3539
		Mobile	082 374 7877

PS Status	Open	Date	29 Jan 2018	Revised PS	n/a
------------------	------	-------------	-------------	-------------------	-----

PROJECT TITLE: Evaluation of the most pragmatic approach to Expected Credit Loss (ECL) estimation

PROJECT GOAL:

Under IFRS9 the concept of lifetime loss requiring PIT estimates for both stage 2 and stage 3 was introduced. Whilst methodologies are in their infancy the current understanding is that a loss rate or direct approach to ECL is allowed for which is far simpler and possibly more accurate than determining each of the parameters PD, EAD and LGD in isolation. The research problem would then be to evaluate the most pragmatic approach given that accuracy of ECL is the primary objective.

HIGH LEVEL DESCRIPTION OF PROBLEM

Expected credit losses have been estimated traditionally by using the formula $PD \times LGD \times EAD$ where PD is probability of default, LGD loss given default and EAD exposure at default. In a retail context models have been built to estimate each of these quantities. The new accounting standard IFRS9 introduces the concept of lifetime loss. In general IFRS9 is vague on the exact definition of life time loss, leaving this open to interpretation. Relevant documents are the guidelines given by the Global Public Policy Committee (GPPC, 17 June 2016) on IFRS9 implementation as well as the Basel Committee on Banking Supervision (BCBS, December 2015) on credit risk accounting for expected credit losses. In the latter document, the Appendix contains supervisory guidance specific to banks applying IFRS9.

In order to forecast impairments under the new guidelines one has to consider how to handle a number of issues, for instance:

- The definition of significant deterioration from initial recognition in the probability of default used to allocate exposures to either stage 1 (12 month ECL) or stage 2 (lifetime ECL);
- Methods for incorporating macro-economic variables into the estimation process;
- Methods for incorporating varying economic scenarios into the final, forward looking determination of ECL on a probability weighted basis.

In this light we want to study and evaluate the impact of estimating the expected credit losses directly by using the loss rate approach as alternative to the traditional PD-LGD-EAD approach. The loss rate approach should be expanded by considering how best to incorporate macro-economic variables (under different economic scenarios) to determine an unbiased estimate of ECL.

PROJECT OBJECTIVES

The objective would be to research the loss rate methodology as an alternative to traditional methods and to evaluate the two methods using an unsecured portfolio, such as instalment finance.

The calibration comparison will be limited to non-impaired assets (stage 1 and stage 2 combined)

OUTPUTS REQUIRED

Report on the loss rate methodology and how it compares with the traditional methodology.

STRATEGIC VALUE TO DIRECTED RISK RESEARCH

This research will increase insight into different methods to calculate expected loss.