DIRECTED RISK RESEARCH PROBLEM STATEMENT

Risk Theme	Retail credit risk	**Problem Nr.**	PS19001

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PROJECT TITLE: Investigation in alternative methodologies to model loss given defaults for impairments

PROJECT GOAL

Absa is interested in alternative methodologies that strive towards ensuring accurate point in time (PiT) LGDs for IFRS9 impairment LGD models.

HIGH LEVEL DESCRIPTION OF PROBLEM

The International Accounting Standard Board published the new and complete IFRS 9 standard in the form of the document titled IFRS 9 Financial Instruments (IFRS, 2014). This IFRS9 standard replaces most of the International Accounting Standard (IAS) 39. It contains impairment requirements that allows for earlier recognition of credit losses. The financial statements of banks reflect the IFRS9 accounting standards from 1 January 2018 (European Banking Authority (EBA), 2016). Banks found that IFRS 9 had a significant impact on systems and processes (Beerbaum, 2015). The IAS 39 standard made use of provisions on incurred losses. Learning gained from the financial crisis showed that expected losses, instead of incurred losses, should be used to calculate the provisioning for banks (Global Public Policy Committee (GPPC), 2016). Under IFRS 9, the expected credit losses (ECL) should be equal to an amount equivalent to the lifetime ECL, if the credit risk has increased significantly. When the converse is true, a financial entity may allow for credit losses equal to 12-month ECL. The ECL model is a forward-looking model and should result in the early detection of credit losses. It is anticipated that this will contribute to financial stability (IFRS, 2014). The ECL is a function of the probability of default (PD), the loss given default (LGD) and the exposure at default (EAD). The focus of this project will be the investigation into alternative methodologies to model the LGD component within the impairment calculation under IFRS 9.

PROJECT OBJECTIVES

The objectives of this project are:

- to investigate alternative methodologies to model the LGD component for impairments (the focus will be retail credit).

- Specifically advantages and risks of alternative methodologies should be indicated. For any weaknesses/limitations identified, possible alternatives should be investigated.

OUTPUTS REQUIRED

- A paper that assesses alternative methodologies to model the loss given default for impairment purposes.
- The paper should include specifically the advantages and disadvantage of such an alternative methodology.

STRATEGIC VALUE TO DIRECTED RISK RESEARCH

Strategic benefits include that a bank will have alternative methodologies to consider to model LGD for IFRS9. A bank will also obtain insight in the risks and advantages of such alternative IFRS9 LGD methodologies.

Bibliography

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IFRS. (2014). IRFS9 Financial Instruments: Project Summary. Retrieved January 31, 2016, from http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Documents/IFRS-9-Project-Summary-July-2014.pdf