
IRB Modelling: Where are we four years down the line?

**Edinburgh Credit Scoring & Credit Control Conference
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**Rebecca Lucas
Risk Specialists Division
Financial Services Authority**

- It is over 4 years since the first waiver directions were granted
- Continuous improvement was expected
- Models and processes have been seriously tested by the downturn

Pre-Basel II



What were firms' strengths, compared to BIPRU requirements?

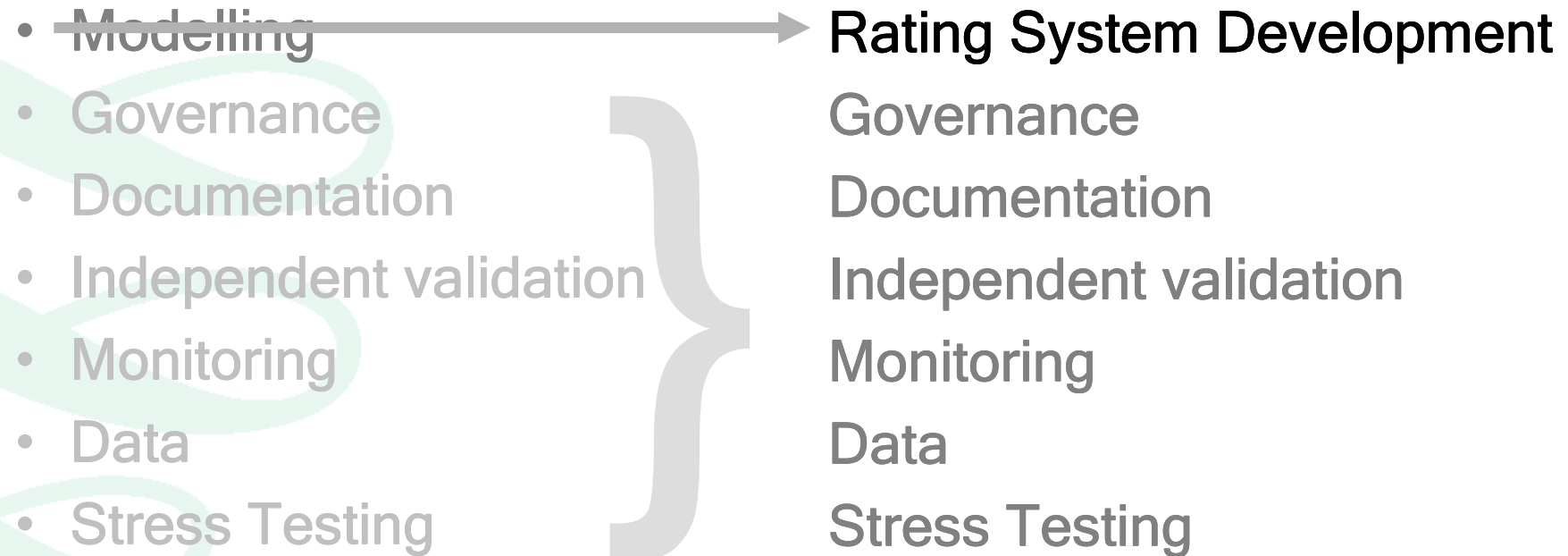
- Modelling
- Governance
- Documentation
- Independent validation
- Monitoring
- Data
- Stress Testing

Basel II demanded improvements in all areas...

When the waivers were granted

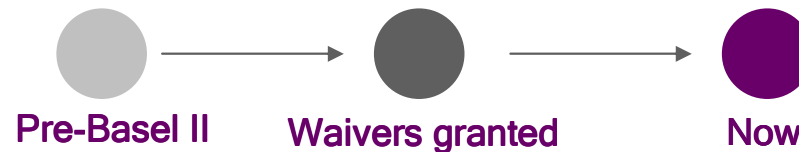


What were firms' strengths, compared to BIPRU requirements?



Improvements made but more expected...

Progress

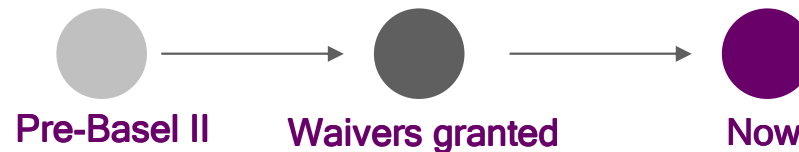


Improvements seen, especially where good governance was already embedded in the organisation

Challenges

- FSA needs to rely on firms' governance
- Are senior management / audit responding to repeated model rejection?

Progress



Progress made; data dependency growing. Historic data couldn't have predicted events of the last 3 years

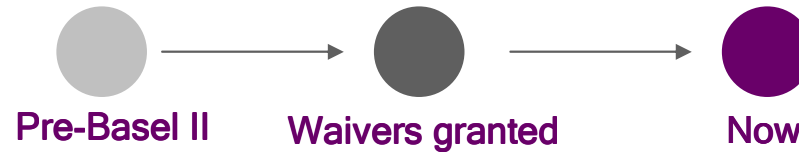
Challenges

- Recording data for future use
- Improving links between systems (e.g. multiple Collections systems, risk & finance)
- Guarding against over-reliance

Rating System Development



Progress



Continuing improvement. Recession challenged models - both downturn assumptions and point in time estimates.
Rank ordering held up far better than calibration

Challenges

- Moving away from a “because the data told me so” approach to one that incorporates more expert judgment - this presents its own challenges

Rating System Development



Challenges

- Rolling out harder-to-model portfolios
- Increasing sophistication of LGD and EAD models in a challenging environment: low interest rate + forbearance = difficult to set expectations
- PiT to TTC approaches for mortgages

- This is challenging for firms, and for us
- Sensitivity analysis is more important than ever
 - Quick answers vs sound logic
- Get sophisticated when you've got the basics

Independent Validation



Progress



Quality and focus varies considerably between firms.

Challenges

- New approaches present challenges - mismatch of between modellers' and validators' understanding.
- Need to keep asking the simple questions regardless of the complexity of the models
- Auditing issues raised by the FSA but not by the validation function?

Monitoring



Progress



Improving. Quality of MI reflects appetite of management - we can often tell that it is not being viewed / understood / challenged.

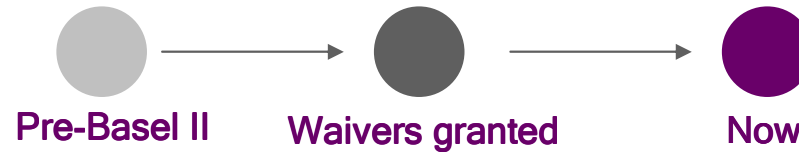
Challenges

- Monitoring of through-the-cycle estimates
- Monitoring LGD in a changing environment
 - ➔ Use of expert judgment, explanation of underlying assumptions, evidence of challenge - monitoring may need to become more transparent and responsive

Documentation



Progress



Very varied quality. If we're struggling to understand the documentation, did management?

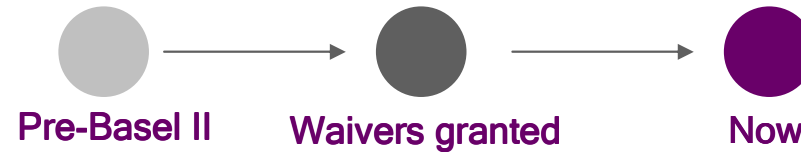
Challenges

- Understand the role it plays in your engagement with the FSA, and what we may infer from its quality
- Do we keep coming back with questions that should have been covered in the documentation?

Stress Testing



Progress



Much work was still to be done when the waivers were granted. Pillar I stress testing is still important.

Challenges

- Stress testing requirements increasing
- Not just a back-room exercise - senior management need to buy into it and understand the risks sufficiently to take action
- We set out in a 2005 paper the key characteristics of a comprehensive stress testing approach

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