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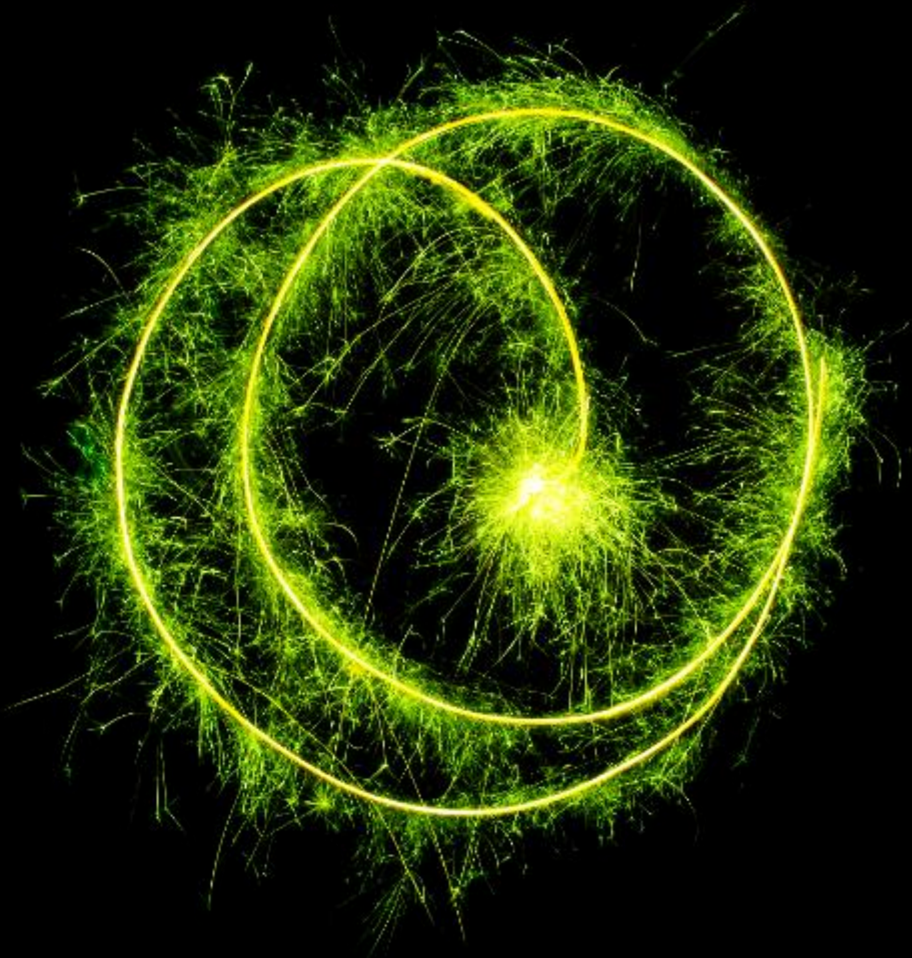
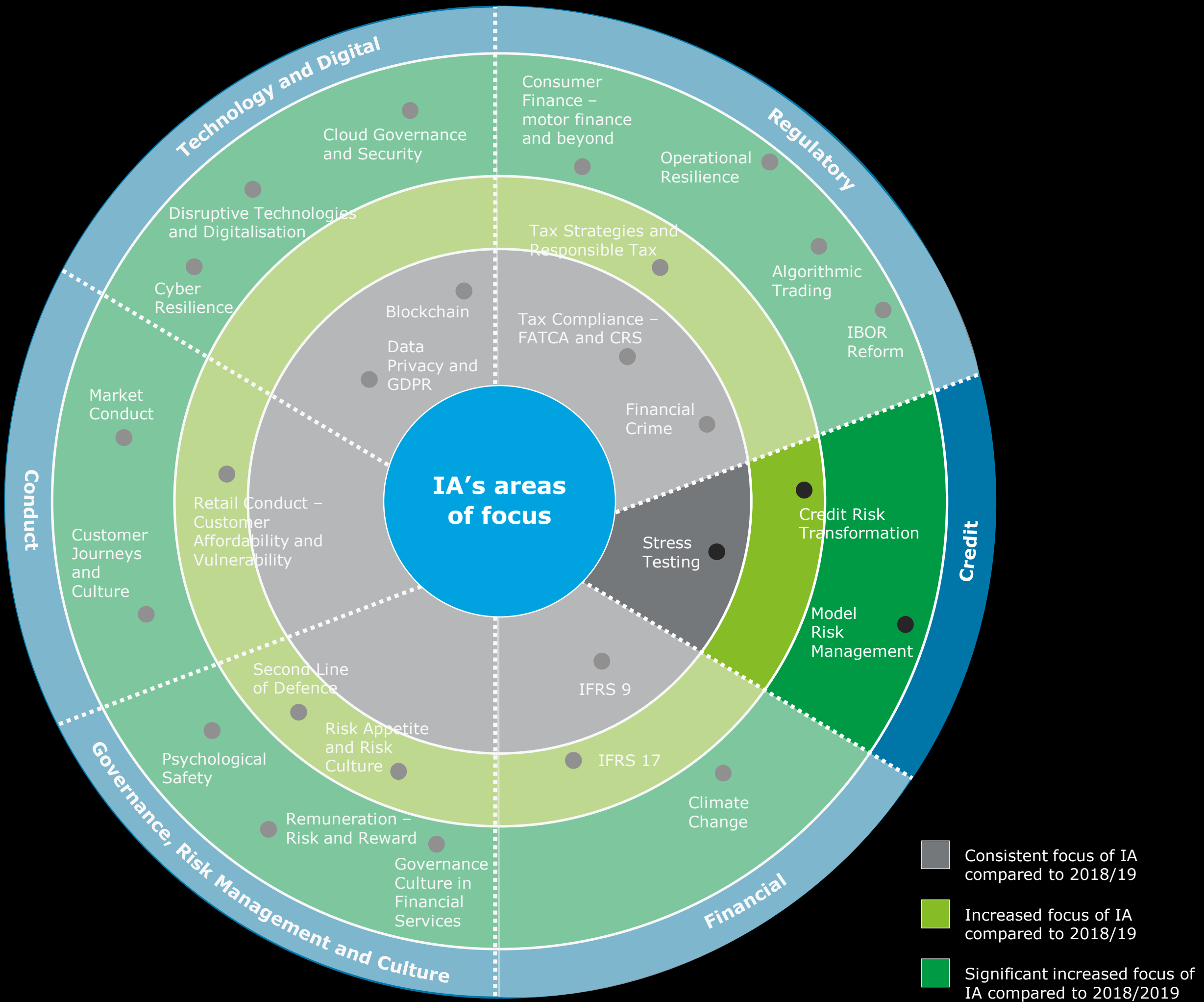


Financial Services Internal Audit
Planning Priorities 2020 – Credit Hot Topics

Introduction

Credit risk remains core to much of the financial services industry and firms' risk management processes remain an area of regulatory focus. Continued political and economic uncertainty in the UK means that stress testing also remains a key area for businesses.



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Key Industry Icons

Banking and Capital Markets

Insurance

Investment and Private Equity

2.1 Credit Risk Transformation

Why is it important?

Credit risk management is a dynamic process and requires continuous re-assessment of the approach in place to prevent adverse impacts in an evolving environment. Key principles of an effective credit risk management process are a forward-looking and a risk-proportionate approach which should be embedded in the end-to-end credit lifecycle.

What's new?

Regulatory challenges are forcing firms to re-examine the cost, efficiency, sustainability and transparency of their risk management requirements.

Firms are using technology to combat these challenges by optimising the end-to-end credit risk management process, for example through:

- **New data sources** – Open banking and SME credit data sharing scheme has meant redevelopment of a number of credit risk models and decisioning processes.
- **New modelling techniques** – Banks are increasingly using Artificial Intelligence/Machine Learning (AI/ML) models in their credit decisioning processes.
- **FinTechs** – Niche FinTechs are increasingly being used for discrete elements of the end-to-end credit risk journey, from data provision to underwriting platforms.
- **New MI and reporting** – The new end-to-end credit processes present new inherent risks to the business which need to be identified, and incorporated into MI and reporting. This reporting covers not just credit risk (quantification and early warning) but also operational risk and conduct risk.

What should Internal Audit be doing?

Area of focus	Description
Credit exceptions	Review new/changed credit underwriting processes and exceptions processes to understand the customer treatment, and the conduct risks associated with this journey.
Model risk management and AI	Review governance around the use of these new decisioning models, including the length of the historical data used and the modelling techniques (AI/ML, etc.) applied.
Third party risk management	Check that third party risk identification and monitoring processes including MI are fit for purpose and consistently and continuously track changes to third party risk profiles associated with FinTechs used in credit risk management.
Risk Appetite	Review the risk appetite framework and assess whether risk appetite statements, metrics and tolerances are appropriate for the changing credit risk management framework.
Early warning processes	Assess resource/capacity and early warning processes to identify whether credit portfolio or horizon issues are identifying deteriorating credit performance.

2.1 Credit Risk Transformation

Are there any potential challenges?

Challenge	Description
Manual underwriting	Ensuring all manual underwriting and exceptions processing is clearly documented to identify any potential credit and conduct issues is challenging.
Expert judgement	The role of the credit officer to provide qualitative and credit structuring insight is important. Utilising this talent effectively will be a challenge for the business and may crystallise in heightened risk.
Early Warning and capacity planning	More digitisation requires a greater focus on early warning indicators and associated capacity planning to ensure that the business can proactively respond to a fundamental change in business and economic conditions.
Data availability and history	The data history for new data sources will not be as long as for traditional sources, so it may create challenges while comparing and using the data.

What Internal Audit skills are required?

- Credit risk experience in performing financial analysis, assessing probability of default, early warning indication and identifying mitigating approach.
- Digital risk skills in evaluating the risks inherent in the end-to-end digital journey.
- Conduct risk skills to evaluate the exception processes and treatments.
- Knowledge of programme language skills and model risk management expertise for evaluating the decisioning models.
- Experience with litigating strategy and structuring deals to maximise probability of recovery.
- Understanding of the key phases of the credit lifecycle and industry practice to overcome key challenges.

What's next?

- Regulators, customers and shareholders are pressuring banks to be transparent in the quantification techniques used in the credit decisioning process.
- Demographic changes such as the rise of the gig economy mean that banks need to change the products they offer and the techniques they use from a credit risk perspective as future potential customers may not have a long employment history or payslip.
- The credit acceptance process is increasingly becoming digitised through straight through processing (i.e. AI, Documentation Intelligence) but manual exceptions will still exist and this process needs to be monitored to mitigate potential conduct risk.

Find out more

- https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/financial-services/deloitte-nl-fsi-credit-risk-measurement-technology-trends-financial-services-report.pdf
- https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-rise-of-the-alternative-workforce.pdf

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2.2 Stress Testing

Why is it important?

Stress testing forms an important component of a firm's risk management toolkit. The quality and the outcomes of a regulatory stress test will directly inform a regulator's assessment of a firm's capital requirements. The risks of a firm running a weak stress testing programme, with untimely delivery or a poor quality submission can be very costly.

What's new?

Regulators – the Bank of England, the Federal Reserve (FED) and the European Banking Authority (EBA) are expected to reassess their concurrent stress testing for 2020 onwards, introducing a number of changes:

- **Scope** – A change in the number of participating banks in each jurisdiction (greater in some jurisdictions, fewer in others).
- **Regulatory Scrutiny** – Increased regulatory scrutiny on the qualitative aspects of the stress testing process.
- **Model** – Greater focus on stress testing model risk management.
- **Efficiency** – Expectations of greater efficiency within the programme to allow firms to:
  i. Coordinate their stress testing approach, where relevant, with other regulatory initiatives such as IFRS9, climate change, etc.; and
  ii. Generate stress results faster and make them more industry-relevant.

What should Internal Audit be doing?

Area of focus	Description
Model Risk Management	Review the adequacy of governance processes, design of the model, risk management controls and documentation around processes and assumptions, in particular expert judgment and post-model adjustments.
Data integrity	Review data integrity controls, including controls over completeness and accuracy of data used in stress testing.
SME input	Internal Audit should liaise with relevant SMEs to understand industry best practice and how the firm's stress testing approach compares.
Alignment with Risk Appetite	Review the impact of measures undertaken as a result of inferences drawn from periodic internal stress testing results. If they are used, consider appropriateness of inputs to inform decisions made to reset the firm's risk appetite.
Superior Capital Planning	Superior capital planning should include: • Evaluation of the appropriateness of the stress scenarios selected. • Assessment of the adequacy of timing of generation of stress results.
Consistency	Internal Audit should consider coordination and cohesion in the firm's stress testing approach, where relevant, with other regulatory initiatives such as IFRS 9, climate change, etc.

2.2 Stress Testing

Are there any potential challenges?

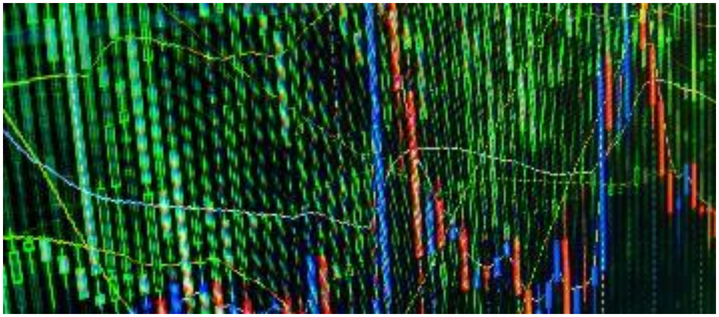
Challenge	Description
Timing & intensity	The timing of the stress testing audit is critical – Regulatory stress testing is a fast paced programme usually condensed within a 2-3 month window.
Scoping	Defining a clear project scope can be challenging for Internal Audit as stress testing covers a wide range of activities such as modelling, data reconciliation, documentation, reporting, programme management and governance.
Regulator's expectations	Continuously tracking and monitoring the regulations and aligning the scope of an audit to the regulatory expectations can be challenging for Internal Audit. This is an area where SME input is encouraged.

What Internal Audit skills are required?

- Sound understanding of the key regulatory requirements and stress testing methodologies.
- Access to regulatory feedback, and knowledge of emerging regulatory focus areas.
- Model risk management expertise for evaluating the decisioning models.
- Project management skills to be able to deliver the audit results in a short time frame.

What's next?

- Regulatory focus on stress testing programmes is expected to continue. Firms should be able to evidence continuous process and methodological improvement in this area.
- The Basel Committee on Banking Supervision issued the final version of its Stress testing principles. The principles focus on the core elements of stress testing frameworks. These include the objectives, governance, policies, processes, methodology, resources and documentation that guide stress testing activities and facilitate the use, implementation and oversight of stress testing frameworks.
- Given uncertainties created by Brexit, stress testing may need to become more regular and varied if it is to remain a valued tool in the business.



Find out more

- https://www.bis.org/press/p181017.htm

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2.3 Model Risk Management

Why is it important?

Firms will need to review and update their Model Risk Management ("MRM") audit programmes to adapt for the increasing expectations of regulators. For many firms, this programme of work will be in the context of the new Internal Ratings Based (IRB) approach waiver applications or IRB change requests to meet new Basel regulatory requirements expected to be in force from 2021. These emerging challenges combined with the evolving nature of MRM will require Internal Audit to complete a range of activities across shorter and more frequent intervals, with existing Model Risk Appetite Statements kept under regular review to ensure they remain fit for purpose.

What's new?

The environment continues to evolve with new regulations requiring banks to establish independent model validation units and enhance oversight. For example:

- Recent ECB TRIM/SSM IFRS 9 reviews noted absence of model risk management capabilities and operational independent validation units.
- PRA feedback on IFRS 9 suggested improvements are required in the quantitative measurement of uncertainty and sensitivity information
- PRA published Model risk management principles for stress testing in April 2018.
- Nordic regulators highlighting the need for independent model validation for models used in Financial Crime Prevention processes

What should Internal Audit be doing?

Area of focus	Description
Model Risk Management Framework	Review new/revised Model Risk Management Frameworks which incorporate new regulatory requirements, new scope (e.g. AI models) and/or new business requirements.
Model Risk testing	Independently assess model risk where mis-estimation risks exist, including: • The development choices, performance testing and outcomes of the model; • The relevant use of the model and alignment to business objectives; and • The process for materiality classification, impact analysis and compliance with regulatory requirements associated with changes.
Independent Validation Function	• Review governance structures in place to manage model risk across the lifecycle. • Assess adequacy of internal validation exercises over material changes to models. Where independent assessment is not completed (or deemed to be ineffective) in first/second line, Internal Audit should undertake the validation exercise ahead of regulatory submissions for approval. • Check the control framework which covers the holistic use of models in the organisation is aligned to any updated Model Risk Appetite and Model risk policy.
Compliance Assessment	Assess compliance of initial IRB applications or extension packages, considering all applicable regulatory requirements.

2.3 Model Risk Management

Are there any potential challenges?

Challenge	Description
No documented internal audit methodology	Internal Audit should develop a methodology and approach for auditing model risk on an end-to-end basis where no such documented methodology currently exists.
Lack of model risk management framework	Lack of appropriate governance is a key risk. When undertaking risk management framework reviews, Internal Audit should confirm that model risk governance and oversight is in place.
Lack of controls framework	Where controls are not formally identified, this can give rise to challenges in Internal Audit's ability to audit. At the planning stage Internal Audit should ensure a model control framework exists/is implemented based on established regulatory requirements and expectations which are extending to financial and non-financial models.

What Internal Audit skills are required?

- Regulatory knowledge including insight into upcoming regulations (including those relating to IRB, IFRS 9, stress testing and other financial models) and established model risk management regulations (e.g. SR 11/7).
- Sound understanding of risk model development and validation techniques.
- Subject matter expertise in all aspects of a Model Risk Management Framework and the Model risk lifecycle (design-build-validate-implement-use) to assess whether controls and policies are consistent with Model Risk Appetite Statements.

What's next?

Model Risk Management will continue to be a focus for firms as they seek to benefit from models to create competitive advantage, gain operational efficiencies and make decisions more effectively.

Two areas of focus are expected to be:

- **Model risk management platforms:** Firms are investing in new technology to manage model lifecycle workflow, model inventory, document repository and analytical/reporting capabilities. Centralised systems will enhance reporting and offer insights, but increase the need for careful control.
- **Model Risk Quantification:** Model risk and conservatism should capture different elements of model error and model misuse. Firms will increasingly develop approaches to quantify model risk exposures, providing the Board with the overview of the models used within an organisation and potential model risk level.

Find out more

- https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/financial-services/deloitte-ch-model-risk-management-js9-final.pdf

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