2nd February 2022

EBA IFRS 9 Implementation by EU Institutions Monitoring Report

Review of observations and findings

IFRS 9 implementation by EU Institutions Monitoring Report

Key findings

In its latest IFRS 9 monitoring report[1], the European Banking Authority (EBA) outlined significant efforts have been made by institutions in the implementation of IFRS 9, especially amidst a global pandemic. However, a wide variety of accounting practices have been observed, driven by the inherent flexible nature of the standard and limited experience to date. More can be done.

SICR assessment

The significant increase in credit risk (SICR) assessment remains one of the largest challenges facing firms. Further scrutiny from supervisors is warranted to ensure a timely assessment of SICR.

- Most institutions use a combination of relative and absolute probability of default (PD) thresholds when approaching the SICR assessment. However, firms using a single absolute threshold are not considered to be compliant with the IFRS 9 standard.
- Both the EBA and the Bank of England[2] encourage firms to make greater use of collective assessments to help identify emerging portfolio risks, in particular during economic crises with similar characteristics as COVID-19, where some relative information at individual level is unlikely to be available.
- In the EBA's findings, only one-third of firms were using collective assessments when determining SICR.
- The calibration of SICR thresholds need to be supported with sound evidence that the thresholds do not lead to a delay in Stage 2 transfers.

Forward looking information

The incorporation of forward looking information varied significantly across banks in the EBA's sample, reinforcing the need for greater supervisory involvement. Key points include:

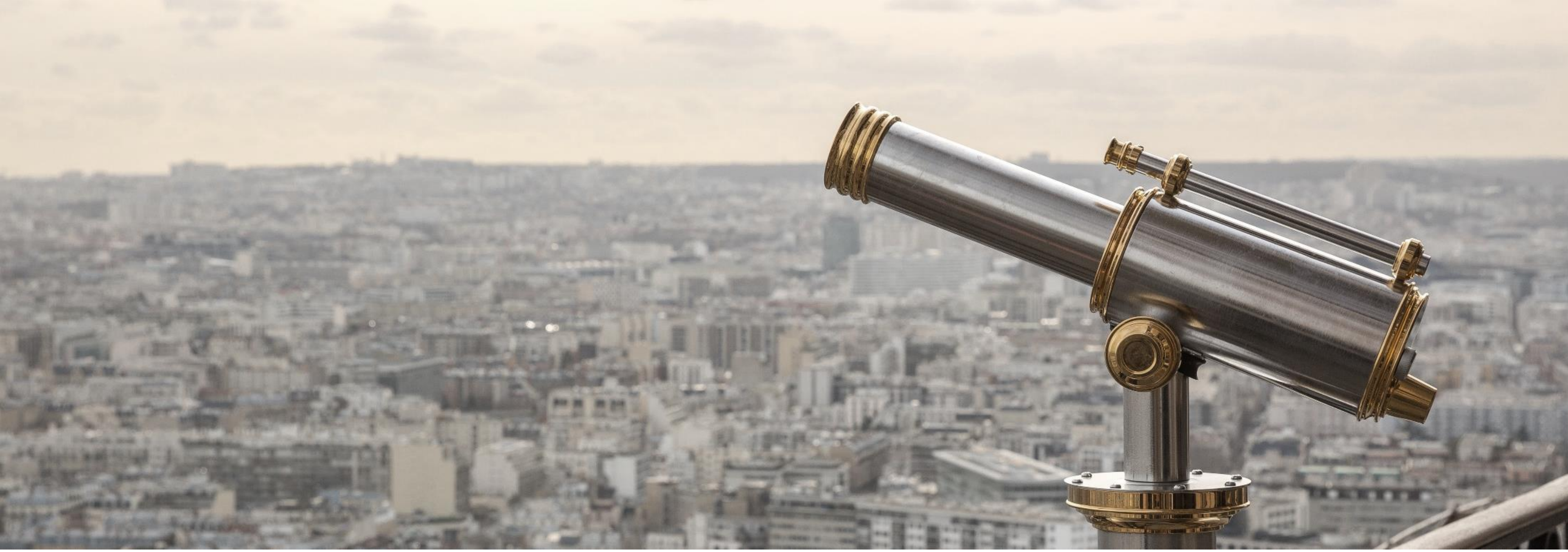
- Despite changes to the economic scenarios during COVID-19, the IFRS 9 12-month PDs are significantly driven by assumptions underlying the base case, raising concerns on the limited degree of the impact from the non-linearity in the scenarios. For example, a 100% weighting towards the downturn scenario, results in a surprisingly low c.20% increase in the final expected credit loss (ECL).
- Some firms attempted reducing the variability in the IFRS 9 estimates by smoothening the macroeconomic scenarios e.g. lagging the impacts of the scenarios. This led to more through-the-cycle (TTC) ECL estimates.
- Extremely long forecasting periods or approaches involving a long mean reversion could result in basing the ECL estimates on information not considered representative.
- Assumptions underlying the downward scenarios require reviewing to ensure they appropriately reflect risks of further deterioration and not include an overly optimistic recovery.

ECL measurement and judgement

With COVID-19 pushing the IFRS 9 models beyond its boundaries, the increasing use of overlays and assumptions resulted in significant divergence in final ECLs.

- In the EBA's findings, 70% of firms did not rely on internal stress testing analysis to determine the overlays to be applied when measuring ECL, potentially causing inconsistencies in risk management practices.
- Despite introducing overlays at the ECL level, some firms experienced lower than expected rise in the 12-month IFRS 9 PD of c.10%, raising questions on whether the overlays can compensate for the despondent change in the PDs.
- The use of overlays will continue to be monitored. Firms should look to understand how they will capture the effects of the overlays into their ECL models and how long the overlays will be maintained for.
- Overlays need to have appropriate internal governance measures.
- With the absence of supervisory validation and high levels of judgement involved, it's crucial for competent authorities to improve their understanding of the IFRS 9 modelling practices and their implications.

[1] IFRS 9 Implementation by EU Institutions Monitoring Report – EBA/Rep/2021/35 – published by the EBA dated 24th November 2021
[2] Letter to Chief Financial Officers of UK banks regarding thematic feedback from the 2020/2021 round of written auditor reporting – published by the Bank of England Prudential Regulation Authority dated 29th September 2021



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