2021 EBA IFRS9 monitoring report

Credo summary and advice

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1 Background

The 2021 monitoring report takes a first look at the implementation of IFRS9 in Europe, focussing exclusively at low default portfolios for now at 33 institutions from 15 EU countries. The reason for this is that individual exposures in low-default portfolios can be easily compared across financial institutions. High-default portfolios will follow later (see the 2019 roadmap).

In this document, we summarize the main points of attention in the monitoring report, react to some points and provide advice to our customers and interested readers in general.

2 Staging assessment

Banks have not widely adopted top-down collective SICR (Significant Increase in Credit Risk) assessments, event during events like the COVID-19 crisis. Alternative approaches, such as manual overlays, do not seem to justify the lack of collective assessment.

There are concerns about the calibration of SICR thresholds using

- a quantile approach,
- absolute thresholds (even in combination with relative thresholds),
- the 12-month PD as a proxy for the lifetime PD without proper rationale,
- the low credit risk exemption,which is backward-looking by nature).

CREDO:

- *Banks do not apply top-down collective SICR because it is impossible to apply in practice. See our Comment Letter to the IASB in response to the IFRS9 impairment RFI.*
- *We advise against using the 12-month PD as a proxy as usually it simply is not a proxy. Rely on staging based on annualized lifetime PD instead, using a threshold between 2 and 3, depending on the volatility of the underlying portfolio.*
- *Use the low credit risk exemption only for your investment portfolio, in line with other banks.*

3 Expected credit loss (ECL) models

The COVID-19 crisis pushed IFRS 9 models beyond their usual boundaries, leading to increased use of overlays and greater divergence in the materiality of ECL impacts.

- Supervisors should have a good understanding of the methodological features underlying the design of these overlays and ensure that credit risk is accurately reflected in them.
- Overlays should be temporary in nature. Continued monitoring of overlays across EU institutions is necessary to assess whether banks will adjust their ECL models or maintain overlays.
- Good governance measures are crucial for the appropriate application of overlays.

Most institutions did not rely on internal stress testing to determine overlays for ECL measurement.

The effects of the COVID-19 crisis are modelled heterogeneously, with variations in how public support measures are incorporated into ECL calculations.

4 IFRS 9 PD variability and robustness

The EBA observes significant variability in approaches for modelling the IFRS9 PD and in the values reported by banks.

In some banks, IFRS9 PDs show relative changes similar to the changes observed in IRB PDs. This is implausible given the point-in-time character, resp., through-the-cycle character of both. In some cases, smoothing of the underlying forward-looking scenarios is to blame for the mild volatility seen in IFRS9 PDs.

5 Incorporation of forward-looking information

The impact of COVID-19 on ECL different significantly across banks.

The market-standard appears to be a 3-years forecasting horizon, after which a gradual reversion to the mean is applied.

The IFRS9 PD estimates are still significantly driven by the assumptions underlying the base scenario, raising concerns on the limited degree of impact from non-linearity.

The EBA is not OK with

- the practice of using a single scenario without any adjustment to reflect the nonlinear impact of less likely scenarios, unless accompanied by a convincing justification.
- approaches using extremely long forecasting periods, or a reversion to the mean over very long timeframes, because it is doubtful whether forward looking info remains relevant over longer periods.
- methods that apply smoothing over time of macro-economic drivers in forward-looking scenarios. The impact of this is felt already in the first three years of the IFRS9 projections and tends to strongly reduce volatility, making IFRS9 results effectively 'through-the-cycle'.
- applying countercyclical effects in scenarios, e.g., following a year with strong decline in GDP by a year in equally strong GDP growth.
- using a reduced downturn scenario during periods of stress.

The EBA wants more scrutiny on the severity of assumptions underlying the downturn scenario, which should be sufficiently pessimistic.

In general, the interplay between IFRS 9 and internal stress-testing remains an important area to further monitor.

CREDO:

- *It is good that there is variability in COVID-adjusted ECL estimates across banks, right? All banks behaving in the very same way would generate an important new source of systemic risk.*
- *The implementation of mean reversion in CREDO IFRS9, using an onset of mean reversion three years after the reporting date, appears to be in line with the EBA's expectations.*
- *Adequate IFRS9 reporting and stress testing go hand in hand.*

6 Classification and measurement

The SPPI (Solely Payments of Principal and Interest) test appears to work well.

However, there are inconsistencies in assessing the business model, especially concerning the criteria of 'frequency of sales' and 'significant in value,' which determine the applicability of a Hold to Collect (HTC) model. There also is ambiguity about whether sales resulting from increased credit risk align with the HTC business model.

CREDO: The EBA's observations are hard to reconcile with the positive findings reported by the IASB following the Post-Implementation Review (PIR) on IFRS 9 classification and measurement!

7 Recognition and derecognition

Financial Asset Derecognition Criteria

Around half of the institutions in the sample apply the 10% criterion alongside qualitative and/or quantitative assessments for derecognition after a modification of contractual conditions. These criteria are applied irrespective of the impairment stage of the financial asset and have remained consistent since implementation.

Effectiveness of Write-off Policies

The majority of institutions report recovery percentages below 10% after write-offs, although rare cases show recovery rates exceeding 30%. High recovery percentages may prompt institutions to review and enhance internal policies to address such occurrences.

Qualitative and Quantitative Criteria for Write-offs

About 75% of institutions use qualitative criteria, while approximately half utilize the 10% criterion, supplemented by other assessments similar to those used for financial liabilities.

Treatment of penalty interests

There is heterogeneity in recognition and presentation practices. Most institutions recognize penalty interest income in profit or loss upon payment. However, some record the income from penalty interest before collection, increasing the carrying amount of Stage 3 exposure.

CREDO: Further guidance is needed on the treatment of penalty interests in IFRS9 impairment calculations, also see our comment letter to the IASB.