2023 EBA IFRS9 monitoring report

Credo summary and advice

Credo
Oudestraat 113
2630 Aartselaar
www.credo.be

Contents

1 Background

Contrary to the 2021 monitoring report that exclusively considered low default portfolios, the 2023 monitoring report looks at classical banking portfolios with higher default levels.

The EBA considers that IFRS9 achieves its main objective of timely and effective recognition of Expected Credit Losses (ECL). However, a thorough inspection of results and practices at thirty-seven EU banks, including one Standardised bank, shows that much work remains to be done. The principle-based nature of the Standard leads to quite some variability in IFRS9 practices, some of which are not OK from a regulatory perspective. By consequence, we may expect increased regulatory scrutiny and guidance in the future.

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 SICR assessment

The objections in the 2021 report are confirmed.

2.1 Collective staging: top down expected, but how?

While the EBA would expect extensive use of top-down collective staging, they find that only one participating bank has applied this in practice.

CREDO: We are not surprised, because we see no good way to apply top-down collective staging without ruining the Use Test. Consider for instance a portfolio of 10 000 very similar credits, currently all in stage 1:

- *We foresee a strong rise in unemployment and expect that it will have a significant impact on this portfolio. However, the unemployment rate has not been included in our ECL model, or staging logic.*
- *We therefore perform a separate collective assessment that properly accounts for the rise in unemployment. It indicates that 10% of contracts in the portfolio will experience a significant deterioration of credit risk and each of them should see its lifetime ECL increase by 100 CU.*
- *Since all credits are nearly identical based on the individual data we currently have, we see no other option than to randomly select 1000 credits and put them in stage 2, with an increased impairment. This would work if IFRS9 were a pure accounting exercise, but we have worked hard to make sure that the IFRS9 impairments are used in a wider range of processes, such as risk-based pricing. The users of our impairments would lose confidence if they were confronted with unexplainable differences in stage and impairment amount.*

We have already signalled the problem to the IASB and hope to also bring it to the attention of the EBA. We do not see how banks can implement top-down collective staging until these regulatory bodies have issued clear examples on how this should be done in practice.

2.2 Quantile approach: still not acceptable

Thirteen out of thirty-seven participating banks report using a quantile-based approach to determine when an increase in lifetime PD is 'significant': based on volatility observed in the past, check what is the expected lifetime PD for, say, the 90% worst performers and use this as a staging threshold.

CREDO: We do not really agree with the EBA's arguments but clearly there is no point in discussing. We advise banks to switch to quantitative staging based on a fixed increase in annualized lifetime PD by a factor between 2 and 3. For more volatile portfolios, a higher factor may be used ☺.

2.3 Other concerns regarding SICR: good to know

Unless solid justification can be given, the EBA still has problems with the following practices:

- Using the Low Credit Risk Exemption for high default portfolios,
- Applying absolute thresholds for stage transfer, even when combined with relative thresholds,
- Staging based on increases in notches on rating scales not accompanied by a method that includes forward looking indicators into the staging assessment,
- Using the 12-month PIT PD as a proxy for the lifetime PD

An increase in annualized lifetime PD by a factor of three is proposed as a new backstop.

CREDO: We encourage our customers to express their staging logic in terms of annualized lifetime PD, using portfolio-specific thresholds between a factor 2 and 3.

3 Overlays

The EBA defines an 'Overlay' as *any manual adjustment or intervention affecting the IFRS 9 ECL or risk parameter estimates resulting from the ordinary application of the IFRS 9 ECL model adopted by the institution* and refers to the section *'What are Overlays?'* on page 45 of the 2021 IFRS 9 monitoring report for more details.

3.1 Collective overlay and collective SICR assessments: not interchangeable

The EBA finds that overlays have become an integral part of the IFRS9 set-ups of many banks. It is reiterated that overlays should be of temporary nature. Furthermore, it remains essential that the use of overlays is accompanied by sound methodological approaches and supported by appropriate governance. Also, efforts must be made to reduce judgment in overlay calibration, which is frowned upon.

The EBA suspects that the limited use of top-down collective staging is partly due to the excessive use of collective overlays. However, these overlays mainly work on the ECL amounts and not on transfers to stage 2. In the EBA's view, collective SICR assessments remain the most suitable and aligned to the IFRS 9 tool to address the lack of information at the individual level, in particular, in the geopolitical and macroeconomic environment that has been experienced recently. Collective SICR assessment approaches , rather than overlays, are expected to be used by institutions on a regular basis.

3.2 How to best introduce overlays? Some bad EBA advice

The EBA prefers the introduction of overlays at granular risk parameter level (PD, LGD, internal rating …) rather than to the final ECL and IFRS9 stage. Half of the surveyed banks use the former approach, the other half stick with the latter approach.

CREDO:

- *We advise against the EBA's recommendation to tune model parameters under the hood. This lacks transparency and may lead to the introduction of uncontrolled model changes outside of the agreed governance. Within your official IFRS9 reporting, you should maintain a strict separation between on the one hand your IFRS9 model, and on the other hand, the overlay, which should be applied to your results only at the very end, in a clearly auditable manner.*
  As far as we can see, the only good argument put forward by the EBA for introducing overlays at the level of individual parameters is that this way, changes in PD models simultaneously impact ECL amounts and the SICR assessment (too often, overlays are found to only impact the ECL). However, this is not incompatible with the idea of a separate overlay at the very end. Compute your overlays in any way you want, using pen and paper, or (better) within a separate stress testing framework, until they become a part of the official IFRS9 model via the agreed governance for introducing model changes.
- *The highly flexible individual and collective management overlays and stress testing functionalities provided by CREDO should amply suffice to meet the EBA's concerns.*

4 ECL calculations

The EBA finds that very few institutions have considered climate and sustainability related ESG risks in their ECL models, although considered to be material.

It is noted that a significant number of institutions rely on specific IFRS 9 models, disregarding, to a large extent, the IRB infrastructure. In this regard, justification from those institutions on the reasons underlying their modelling decisions is expected.

The 2023 monitoring report also discusses the use of data from Covid years in IFRS9 modelling. Data records from these years should not be used if they lead to a significant loss in model performance, or biases calibrations.

CREDO: It may well be that massive state interventions and active credit risk management by banks (lifting covenants, etc.) are a part of the 'new normal' and will reappear in the future. We are therefore not convinced that removing Covid-era data from modelling histories is the best way to tackle this problem. A better approach may be to put more emphasis on risk drivers that are impacted by state support in the same way as default rates. Some banks that based their forward-looking estimates on forecasts for unemployment and bankruptcy rates rather than, say, GDP growth, have decent back tests even for Covid years.

5 Forward-looking information

The EBA continues to look, in vain, for pronounced non-linear effects in the impairment calculations.

The usage of one single scenario without further adjustments for non-linearity is clearly not OK. The market scenario clearly is to use three forward looking scenarios (base/up/down). Surprisingly, the weights applied to these three scenarios are remarkably in line at many of the surveyed banks. The EBA suspects that this is due because too often the weights are set in a purely judgmental manner. A clearer methodology is needed for this.

The application of mean reversion ('smoothing') is an understandable cause of concern, as it greatly softens the impact of the forward-looking scenarios.

If no sound internal forecasting knowledge is available, then banks should consider using the forecasts external bodies (central bank, …).

It is stressed that not only PD, but also LGD, should be impacted by the forward-looking scenarios.

CREDO:

- *For individual contracts, IFRS9 impairments frequently exhibit strongly nonlinear behaviour, but aggregate portfolio impairments are to a good approximation a continuous, derivable function of forward-looking parameters. For small deviations from the base scenario, mathematics will tell you that results vary in a linear fashion – which is exactly what the EBA sees. To see real non-linearity, banks should include extreme stress scenarios, rather than plausible business scenarios, into their IFRS9 forecasts. Do the IASB and EBA agree that this is necessary?*
- *The considerations regarding mean reversion in the 2023 monitoring report are not particularly clear. See the 2021 for a better discussion. The EBA has essentially two objections: (1) Banks tampering with the forward-looking scenarios by applying smoothing to forward looking indicators within the first 3 years of the IFRS9 projections, or 'countercyclical' interventions such as following a year with strong decrease in GDP by a year with an equally strong increase; (2) Using excessively long forecasting periods before mean reversion kicks in. The EBA questions whether any forward-looking info can still be considered relevant beyond a horizon of a few years. We believe that the implementation of mean reversion in CREDO IFRS9, with onset of mean reversion three years after the reporting date, is in line with the EBA's expectations.*
- *Regarding scenario weights: see Credo's approach to generating forward looking scenarios around the base scenario.*

6 Back-testing

A large part of the 2023 monitoring report is devoted to back-testing. Some banks are seriously lagging in this respect. Most banks do some sort of back-testing, but often this is limited to specific parts of the IFRS9 calculations (e.g. only the 12-month point-in-time PD) and does say enough about the robustness of the overall ECL and impairments. In addition to this, back-testing processes should be formalized more, e.g. by defining concrete thresholds beyond which concrete actions must be undertaken to improve models. Thus far, back-testing outcomes seldom lead to concrete actions, it is found.

The EBA expects banks to retroactively test not only ECLs, but also the

- predictive power of the SICR assessment
- quantification of overlays
- predicted forward-looking scenarios.