In the Spotlight

An industry focus on IFRS 9 - banking

Avoiding a crisis: ensuring that IFRS 9 ECL is 'fit for purpose' in advance of a downturn

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Background

Many banks developed and first implemented IFRS 9 in a relatively benign credit environment. That credit environment cannot continue forever. Although the same technical requirements will apply, in this 'Spotlight' we identify key accounting aspects of IFRS 9 ECL that are likely to have increased importance when an economic downturn approaches.

These key accounting aspects include: implications of lagging information; simplifications / expedients that might no longer be appropriate; and use of multiple economic scenarios. Preparers should therefore consider these aspects in advance of a downturn, and make changes to ECL processes and controls where necessary, to ensure that their ECL approach will remain 'fit for purpose' in a downturn or crisis.

The accounting aspects discussed are not exhaustive, and a preparer's responses will need to reflect their specific circumstances, as well as their ECL methodology design and application. Preparers will also need to consider specific modelling aspects that are not dealt with in this 'Spotlight'. References are included to further guidance, available in PwC's Manual of Accounting, for subscribers to inform.pwc.com.

Lagging information

In a downturn, as economic conditions deteriorate, there is a greater likelihood of information with a potentially material impact becoming available only close to the reporting date, or even afterwards. Relevant accounting considerations include:

- *Use of more forward-looking qualitative indicators of SICR* – In a downturn, qualitative indicators might become more important in identifying a significant increase in credit risk (SICR), where this is not yet reflected in quantitative indicators such as probabilities of default (PDs). This could be the case, for example, for wholesale exposures for which key information is contained in public financial reporting published only after the date the lender's financial statements are finalised. Therefore, the expectation of an event, as well as its actual occurrence, will become more important in identifying SICR. This is shown in the list of factors set out in IFRS 9 which refer to what is expected to occur, such as an actual or *expected* significant change in the financial instrument's internal or external credit rating. [IFRS 9 para B5.5.17(d)]. In addition, market-based indicators, such as changes in the price of a borrower's debt and equity instruments [IFRS 9 para B5.5.17(c)(iii)], might lead other indicators in identifying the occurrence of a change in credit risk, and so have increased importance.

- *Use of a 'top down' assessment of SICR* – Since conditions develop more rapidly in a downturn, there is a greater likelihood that, at a reporting date, evidence of a significant increase in credit risk will only be available at a macro level, with a lag before this becomes evident at the individual instrument level. Where this is based on reasonable and supportable information, it should still be reflected in ECL in a 'top down' manner – for example, by applying an increase in PD to the whole of an affected portfolio. See also FAQ 45.42.1.

- *Capturing 'late breaking news'* – In more volatile economic conditions, there is an increased likelihood of 'late breaking news' that could materially affect the ECL estimate emerging after the reporting date. For example, borrowers exposed to seasonal sales patterns such as retailers, reporting financial difficulties shortly after the calendar year-end. This information will need to be assessed, to determine whether or not it is an adjusting post balance sheet event. See also FAQ 45.64.1.

- *'Stand back' test* – Once the ECL estimate has been calculated, it should be assessed as part of a 'stand back' test, to ensure that it appropriately captures all necessary factors, given the greater risk of omission in a more volatile economic environment. Such factors may affect expected lives and exposure at default (EAD) if voluntary prepayment rates are expected to decline, as well as loss given default (LGD) or PD. Where omissions are identified and cannot be captured in the main modelled ECL, it will be necessary to capture these via a post model adjustment or 'overlay' to the ECL estimate (see also below). Where models have not previously been used in a downturn and there is limited detailed information available, greater judgement will also be required in estimating the impact of any omissions on ECL. [IFRS 9 para B5.5.50]

Simplifications / expedients

In a downturn, there is a greater risk that simplifications or expedients in the ECL implementation give rise to materially different outcomes, so may no longer be appropriate. Examples include:

- *Low credit risk (LCR) exemption from assessing SICR* – The LCR exemption is typically used for securities with an investment grade credit rating from an external credit rating agency. However, in a downturn, there is a greater risk that credit ratings become stale, because there is often a time lag between the credit risk increasing and a downgrade occurring. IFRS 9 only gives an external investment grade credit rating as an example of what *might* be considered to have low credit risk – the broader principle is that 'low credit risk' should be determined with reference to the perspective of a market participant. [IFRS 9 para B5.5.22]. Therefore, even if the external credit rating still shows as investment grade, if that is only due to a time lag and a market participant would no longer consider the instrument to have low credit risk, the LCR exemption will not apply and the instrument will need to be assessed for SICR.

- *Use of 12-month PD for assessing SICR might no longer be appropriate* – When a downturn is expected to occur, for example, in 12–24 months' time, there is a greater risk that changes in the 12-month PD might no longer be a suitable proxy for changes in the lifetime PD. Also, if PDs have generally increased since initial recognition (so that there is less 'headroom' against the SICR threshold), the impact of even small differences between 12-month and lifetime PDs could become more significant. See also FAQ 45.27.1.

- *Materiality judgements* – Simplifications justified on the grounds they have no material impact on ECL might need to be revisited as a downturn approaches. For example, if the effect of discounting was previously considered immaterial, but expected lives of assets are expected to lengthen significantly in a downturn so that the effect of discounting increases, a change may be required, to appropriately reflect this in the measurement of ECL.

- *Post model adjustments or 'overlays'* – In a downturn, there is a greater likelihood that management is unable to reflect rapidly changing circumstances in the 'bottom up' modelled ECL, and so would capture this instead in a more simplified way as a post model adjustment (PMA) or 'overlay'. Care should be taken to ensure that such PMAs comply with all of the requirements of IFRS 9 as if they had been incorporated in the modelled ECL. For example, PMAs should take account of the stage allocation of the relevant exposures and they should consider multiple economic scenarios. In addition, PMAs should not result in a 'double count', because the factor is already wholly or partially reflected in the modelled ECL. Finally, the basis for reversing the PMA should be clear.

Multiple economic scenarios

Depending on the way in which a bank has implemented multiple economic scenarios, its response to an approaching downturn might vary. Different possible responses may include:

- *Existing scenarios might need to change* – For example, if a bank had used three scenarios (base case, upside and downside), each scenario might shift, so that what was the downside now becomes the base case, what was the base case now becomes the upside, and a new downside(s) is added.

- *Additional scenarios might be needed* – As economic conditions deteriorate, downside scenarios that were previously excluded, because their very low weighting meant that including them would not have resulted in a material impact, might now need to be included. Additional scenarios might also be needed for only some segments, for example in particular portfolios / exposures (e.g. oil & gas exposures or real estate exposures) or particular geographies / regions that have material non-linearities not present in other portfolios. See also FAQ 45.72.4.

- *Downside scenario weightings might need to increase* – If scenarios are kept consistent over time (with everything else being equal), as a downturn approaches, the weightings applied to the downside scenario(s) would be expected to increase. However, as a downturn progresses it may then be judged that the weighting of upside scenarios needs to increase, to reflect the greater possible upside at that point in the economic cycle. See also FAQ 45.72.5.

- *Common scenario weightings might no longer be appropriate across all portfolios* – As economic conditions deteriorate, it is more likely that different scenario weights will be needed for different types of loan, to appropriately capture their different non-linearities. See also FAQ 45.72.6.

Other

Further implications that should be considered include:

- *Impact of changed management plans* – In more extreme economic conditions, management might choose to adopt different business strategies. For example, in the past, a bank might have had a policy of minimising customer hardship. However, in a future forecast downturn, it might – with regulator agreement – plan to accelerate foreclosures. It is appropriate to reflect these changed plans in the ECL estimate where they are based on reasonable and supportable information. This is due to the requirements in IFRS 9 to consider forward-looking information and to remove from historical data the effects of conditions in the historical period that are not relevant to future cash flows. [IFRS 9 para B5.5.52]

- *Re-segmentation* – IFRS 9 permits the assessment of SICR to be performed on a collective basis, where financial instruments have shared credit risk characteristics [IFRS 9 para B5.5.5]. Other aspects of the ECL calculation might also be performed on a collective basis. In more volatile economic conditions, there is a greater risk that previously small differences in credit risk characteristics become more significant, or that the characteristics driving credit risk change. Where this is the case, it might become necessary to re-segment the population of financial instruments, to ensure that information is not obscured by grouping together financial instruments with different credit risk characteristics.

- *Appropriate disclosures might change* – In a downturn, there is a greater likelihood that small changes could have a larger effect. For example, increasing the weighting for downside economic scenarios by only a small amount could push a large group of exposures already close to the SICR threshold from stage 1 into stage 2, with a significant uplift in the ECL. In such a situation, more granular disclosure to explain this may be appropriate. The nature of reasonably possible changes in ECL in the next 12 months could also change significantly, in which case disclosures previously provided on critical estimates might no longer be appropriate and might require updating. [IAS 1 para 125]. More broadly, banks should consider what other disclosures to provide, in order to build confidence in the market ahead of a downturn, to help investors anticipate likely possible consequences under IFRS 9, and to help avoid unexpected surprises.