EBA EUROPEAN BANKING AUTHORITY

Main takeaways from the IFRS 9 monitoring report

EFRAG Board conference call

26 January 2022

Agenda

1 **Background**

2 **Main takeaways from the IFRS 9 monitoring report and next steps**

3 **IFRS 9 IASB´s post-implementation review**

1. Background

Main objectives of the report

- Assist supervisors' evaluation of the quality and consistency of the ECL frameworks implemented by EU banks, to contribute to a high quality and consistent application of the IFRS 9 standard.

- Feed the discussions on IFRS 9 implementation with banks, auditors, and standard setters, in particular the post-implementation review (PiR) of IFRS 9, following the International Accounting Standards Board (IASB) work plan.

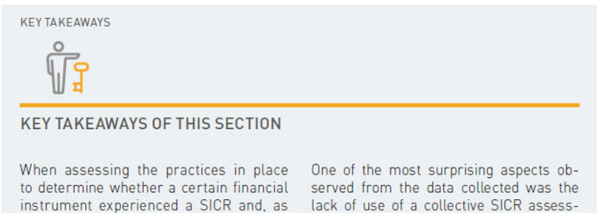
1. Background (cont.)

Structure and Content of the report

- The report is structured in the following manner:
  - Part 1 (Introduction): activities conducted by the EBA on IFRS 9 implementation, including the main objectives of the report;
  - Part 2 (Main findings and observations): findings from the monitoring activities performed, with an emphasis on practices observed in the context of Covid-19;
  - Part 3 (Next steps): future planned EBA activities in the context of IFRS 9 monitoring.

The report includes specific boxes aimed at:

- Summarising the main takeaways for each section (grey boxes);
- Illustrating the methodological approach for the different quantitative analyses conducted (blue boxes);
- Providing a description of the main aspects of the standard (didactic boxes in green).

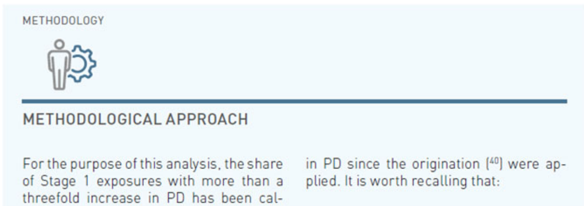


KEY TAKEAWAYS

KEY TAKEAWAYS OF THIS SECTION

When assessing the practices in place to determine whether a certain financial instrument experienced a SICR and, as

One of the most surprising aspects observed from the data collected was the lack of use of a collective SICR assess-

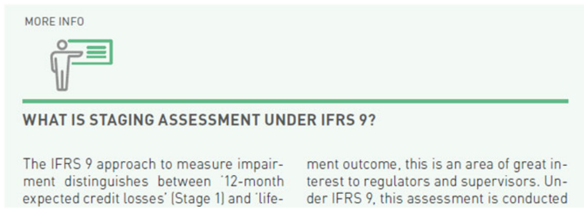


METHODOLOGY

METHODOLOGICAL APPROACH

For the purpose of this analysis, the share of Stage 1 exposures with more than a threefold increase in PD has been cal-

in PD since the origination [40] were applied. It is worth recalling that:



MORE INFO

WHAT IS STAGING ASSESSMENT UNDER IFRS 9?

The IFRS 9 approach to measure impairment distinguishes between '12-month expected credit losses' (Stage 1) and 'life-

ment outcome, this is an area of great interest to regulators and supervisors. Under IFRS 9, this assessment is conducted

2. Main takeaways and next steps

Main takeaways

- A wide array of practices on the business model assessment and consequent classification of financial instruments. Some discrepancies have been observed in the derecognition of financial assets and/or recognition of accrued interest *(please see part 3 of the presentation).*
- Banks made significant efforts to implement IFRS 9. Divergent practices observed linked to the inherent flexibility and the limited experience to date. No single practice has turned out to be a strong driver of the ultimate levels of provisioning.
- Concerns on the timely transfer to Stage 2. Limited use of collective assessment and/or SICR overlays. Under an economic scenario with high uncertainty a collective approach is expected to assume particular relevance.
- Models working outside their boundaries and relying on an increased use of overlays. ECL models more sensitive to the cycle (when compared to prudential ones). Significant differences have been observed in the approach used for the incorporation of FLI.
- The variability in the IFRS 9 12 month PDs increased during the pandemic while the IRB PDs remained substantially stable. This outcome is mainly due to the higher increase in the IFRS 9 PD estimates reflecting their more point-in-time (PiT) nature and the effects from the incorporation of forward-looking information.

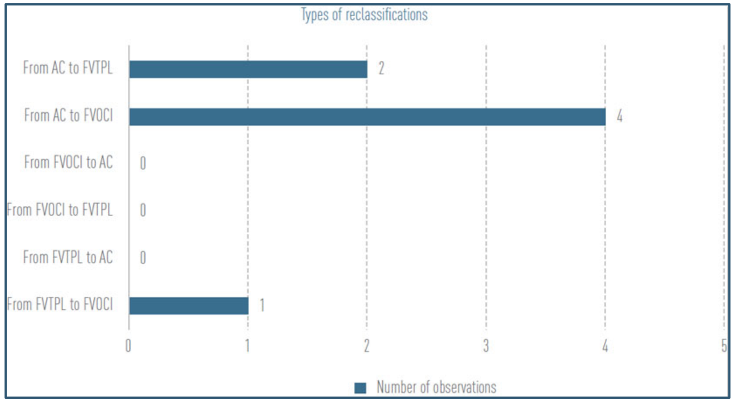
Next steps

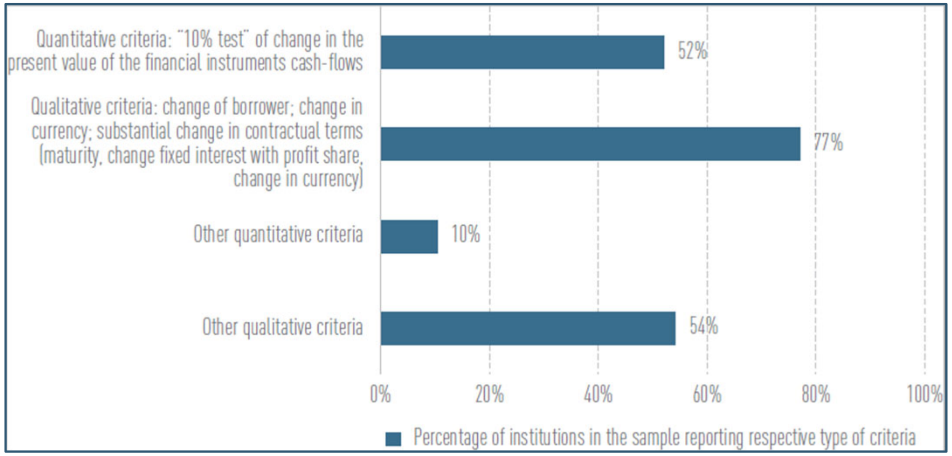
- EBA letter to the IASB on the request for information – IFRS 9 post-implementation review on IFRS 9 to be finalised and submitted.
- In line with the staggered approach from the IFRS 9 roadmap, the EBA will continue working on the integration of the HDPs in the ITS on supervisory benchmarking.
- EBA Staff continues its efforts on the development of an analytical tool to help supervisors in using the ITS data for benchmarking purposes (in line with the tool existing for credit risk purposes).

3. IFRS 9 IASB´s post-implementation review: EBA report

Reclassifications between accounting categories

- Very few reclassifications were observed, in line with the spirit of IFRS 9.
- Impact in CET1 capital not material, but cannot be excluded that it would be for other institutions not in the sample. Still a matter of relevance from a supervisory perspective.





Derecognition of financial assets

- Some discrepancies in the implemented practices observed across institutions with reference to the criteria to de-recognise a financial asset.
- Use of quantitative threshold (10%) vs qualitative assessment.
- High percentages of recoveries after write-offs represent a matter of concern (33% of the sample indicating a % > than 10%).

3. IFRS 9 IASB´s post-implementation review: EBA letter

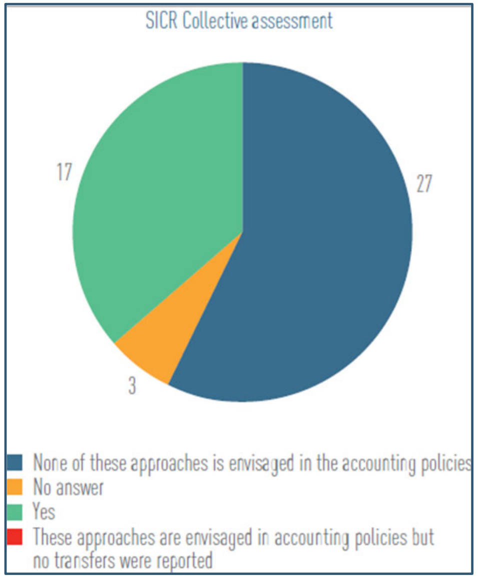
Section RfI	Scope of questions	Main topics covered
2. Business model for managing financial assets	a) Business model assessment working as intended; b) Consistent application of business model assessment; c) Unexpected effects	• Distinction between business models working well but some room for refining. • Various approaches to assess materiality and frequency of sales to be consistent with HTC business model. • Reclassifications.
3. Contractual cash flow characteristics	a) Cash flow characteristics assessment working as intended; b) Consistent application of cash flow characteristics assessment.	• No material influence of SPPI on the classification of non-trading debt instruments. • Different practices observed but no specific concerns. • ESG instruments.
4. Equity instruments and other comprehensive income	a) Option to present fair value changes on investments in equity instruments in OCI working as intended; b) Election to present fair value changes in OCI; c) Unexpected effects.	• No evidence that new rules are negatively affecting the long-term investments held by the banking sector.
6. Modifications to contractual cash flows	a) Requirements for modifications to contractual cash flows working as intended. b) Consistent application of requirements for modifications to contractual cash flows	• Multiple approaches / criteria to assess whether a financial asset should be derecognised. • Write-off policies observations.
7. Amortised cost and the effective interest method	a) Effective interest method working as intended. b) Consistent application of effective interest method.	• Presentation of regular interest for Stage 3 instruments / penalty interest income recognition: different practices observed. • Other aspects: ESG; TLTRO III.

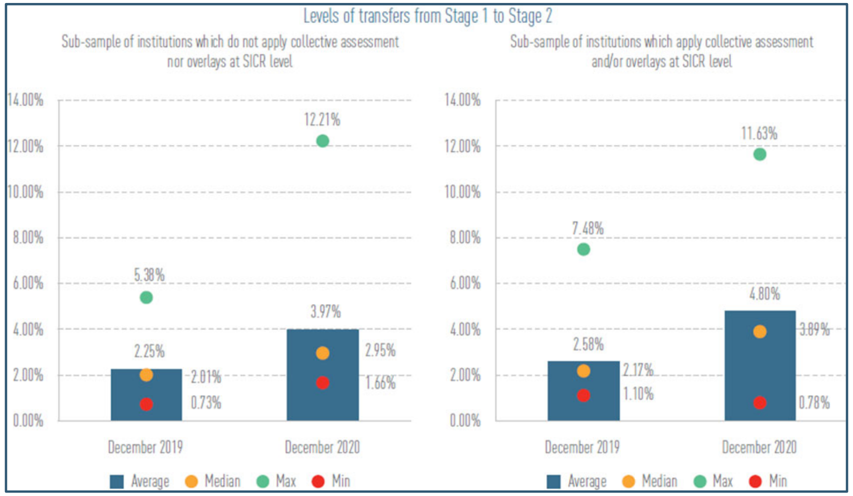
Annexes

Staging assessment

- The evidence collected raise concerns on the timely transfers to Stage 2.
- Some practices have been identified that deserve further scrutiny from supervisors:
  - Combination of absolute and relative thresholds, with both criteria needed to be met in order to trigger a transfer to Stage 2; and
  - SICR thresholds based on a 'quantile approach'.
- Lack of collective assessment not being "compensated" by overlays / manual adjustments.
- While SICR collective approaches and / or overlays are not being used by a relevant number of institutions, those that were doing so as of June 2020 have reported a higher level of transfers to Stage 2. This highlights the importance of these approaches and reinforces the need for further supervisory scrutiny on their application.

	No top-down approach for collective assessment	Top-down approach for collective assessment	Total
No overlays	38%	4%	42%
Overlays	47%	11%	58%
of which COVID	15%	4%	19%
Total	85%	15%	100%



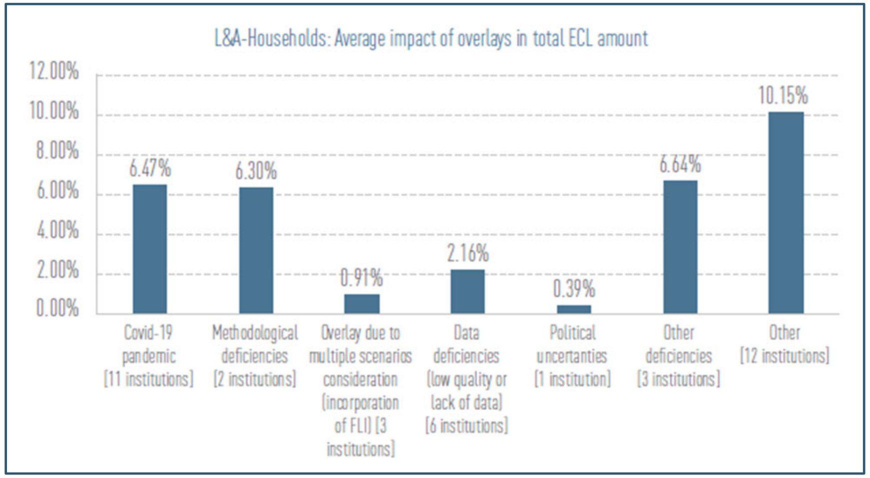


ECL models

- As a response to the Covid pandemic, some institutions introduced post-model adjustments/overlays either at i) the level of the IFRS 9 risk parameter (e.g. PD, LGD and/or EAD) or ii) directly at the ECL level. These overlays can have a material impact on the final ECL.
- Monitoring of overlays is key, and great focus should be put on the processes and governance arrangements around them.
- Needed changes on a more permanent basis to existing models should be a relevant point of attention to supervisors.

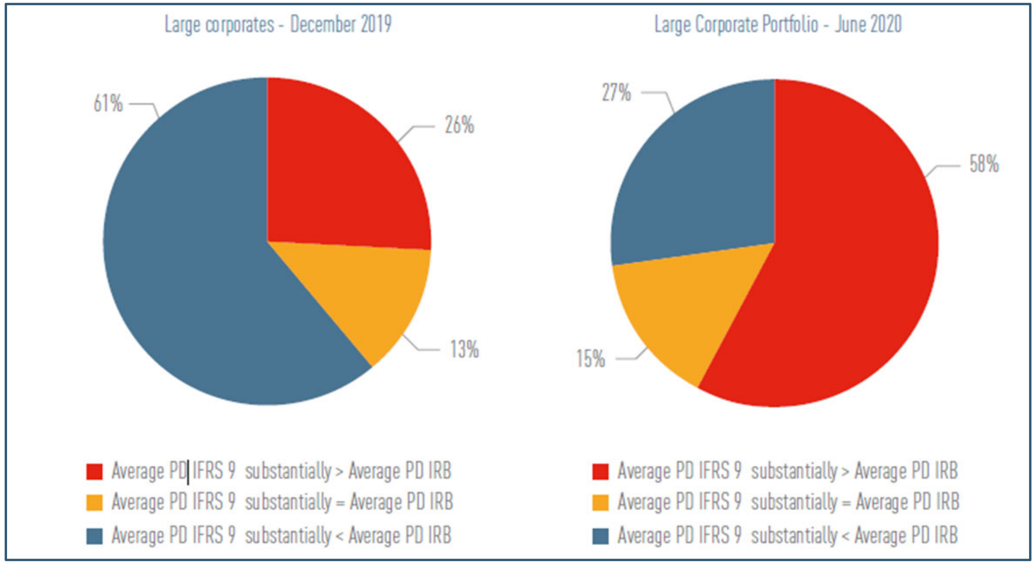
Share (%) of ECL associated with overlays applied at the ECL level

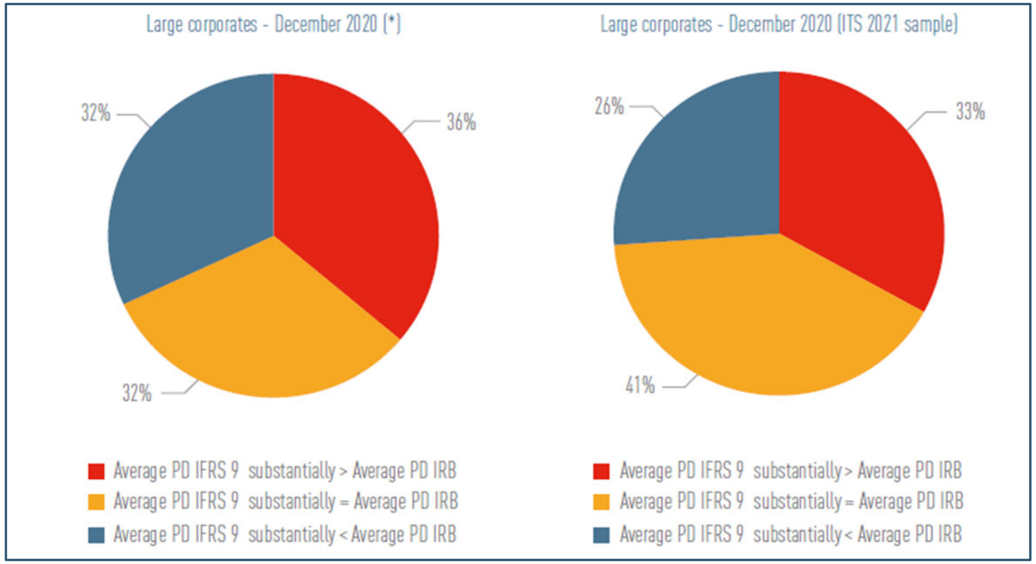
Portfolio	2019			2020		
	Number of institutions	Average	Median	Number of institutions	Average	Median
Sovereign Sample	10	13.84%	0.45%	10	9.04%	1.78%
Institution Sample	10	6.18%	0.84%	10	9.73%	0.98%
Large Corporates	20	14.40%	0.23%	20	16.59%	6.61%
Debt Securities	3	10.45%	0.00%	3	5.67%	6.24%
L&A Non-financial corporations	30	6.95%	1.08%	30	11.20%	5.83%
L&A Households	25	6.21%	2.00%	25	9.66%	6.40%



PD robustness and variability

- IFRS 9 12-month PDs increased during the pandemic, due to the incorporation of FLI, while the IRB PDs remained substantially stable.
- Higher increase in the IFRS 9 PD affected the interplay with the IRB (in June 2020, majority of banks with IFRS 9 12M PD > IRB). Evidence that interplay between the two PDs is going back to a situation pre-COVID-19.
- Institutions with the lower increase in IFRS 9 12-month PD used Covid-19 ECL overlays. In many cases, the impact of these overlays on the ECL amount is quite limited (below 10%), raising interrogations on whether they can compensate the lack of reactivity of the IFRS 9 PD.
- Some of those institutions with the lower increase in IFRS 9 12-month PD introduced practices for the incorporation of FLI, that deserve further supervisory scrutiny or showed an increase in the IFRS 9 PD similar to the IRB PD (concerns on limited FLI impact).





Incorporation of forward-looking information (FLI)

- The evidence collected reinforce the need for supervisors to further scrutinize:
  - the approaches for FLI incorporation in ECL, including (i) the definition of the scenarios and (ii) their impact on the ECL amount;
  - the interplay between IFRS 9 and internal stress testing scenarios, to get a better understanding of the practices in place.
- Some practices have been observed that deserve further consideration from supervisors:
  - Use of smoothing factors to the relevant IFRS 9 macro-economic variables (i.e., GDP);
  - Countercyclical changes in the severity of the downward scenarios;
  - Lack of update in the macroeconomic information (reliance on pre-Covid-19 forecast);
  - Changes in the IFRS 9 scenarios or probability weight to reduce the impact of worst-case scenario.

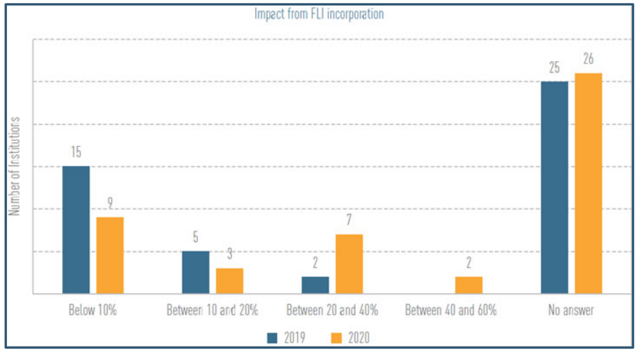


Figure 56: Impact on the total ECL recognised in the reference period when applying 100% probability weight to most upward and downward scenarios

Answering: 41 Institutions	Impact in ECL when applying probability of 100% to...	
	Average 2019	Average 2020
... the most upward scenario	-13%	-12%
... the most down-ward scenario	18%	22%

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