Introduction

In the aftermath of the global financial crisis, the G20 asked global accounting standard setters to replace incurred loss approaches with expected credit loss (ECL) approaches. The global financial crisis revealed that the recognition of credit losses under incurred loss approaches happened “too little and too late”. This pattern of recognition of credit losses had strong procyclical effects, as most losses were recognised during the downturn and not anticipated. At the G20’s request, the International Accounting Standards Board (IASB) issued IFRS 9, which includes an ECL approach. IFRS 9 entered into force in the EU in 2018.

The European Systemic Risk Board (ESRB) is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. The ESRB was created in 2010 following a recommendation in the De Larosière Report, which called for “a Union-level body [to] be established with a mandate to oversee risk in the financial system”. The regulation establishing the ESRB was published in December 2010, and a new regulation introducing minor amendments was published in December 2019. Chaired by the President of the European Central Bank (ECB), the General Board of the ESRB comprises all the governors of the national central banks of the Member States, as well as the heads of all the EU supervisory authorities.

The ESRB has published three reports on the ECL approach in IFRS 9. The first report was published in 2017, following a request by the European Parliament. The report concluded that IFRS 9 could be beneficial for financial stability if soundly implemented. However, it also highlighted that “IFRS 9 could have certain procyclical effects derived from the cyclical sensitivity of the credit risk parameters used for the estimation of ECLs and from the shifts of exposures between stages”. To this extent, the report identified five issues that merit attention from a financial stability perspective, two of them directly referring to the ECL approach and focused on procyclicality and less sophisticated banks. The report acknowledges that the introduction of the ECL approach in IFRS 9 implied a paradigm shift away from IAS 39, entailing “a large degree of sophistication (e.g. when requesting expected losses to be computed as an average across several macroeconomic scenarios). This need poses challenges related to the lack of data or experience relevant to the
required modelling as well as the role of managerial judgement and discretion in the modelling process". A second report analysing differences between the CECL standards developed in the United States and the ECL approach in IFRS 9 followed in 2019. The report highlighted that "the application of the concept of a 'significant increase in credit risk' is important to ensure that the financial stability benefits of the expected credit loss approach are effectively reaped". In 2019, the ESRB published a third report on the cyclical behaviour of the ECL approach in IFRS 9. While supporting the benefits of the ECL approach for financial stability, the report cautioned that "The implementation of IFRS 9 by banks may raise concerns from a financial stability perspective should it lead to suboptimal outcomes". In relation to these suboptimal outcomes, the ESRB report mentions the excessive weight given to the baseline macroeconomic scenario, the banks’ criteria for determining a significant increase in credit risk, and the ability of and incentives for banks to promptly incorporate all new information available on the expected trend of the economic cycle into their ECL models.

In its response to the request for information, the ESRB mainly relies on the points raised in its three published reports, adding evidence from the implementation of IFRS 9. While the ESRB’s response does not cover all the questions raised in the request for information, it does focus on those most related to financial stability and the findings of the three published reports. This response will be published on the ESRB website after it has been submitted to the IFRS Foundation.

**Question 1 – Impairment**

In principle, compared with the incurred loss approach in IAS 39, the introduction of the ECL approach in IFRS 9 should lead to an earlier recognition of credit losses over the cycle. While the ESRB is of the view that the ECL approach in IFRS 9 has had a positive impact on the EU financial system and on financial stability, it also acknowledges certain important factors in its practical implementation (such as those related to the imperfect foresight of banks or the discretion granted to banks in some areas) and the room for further simplification in the standard. Amendments to IFRS 9 addressing the parts of the standard associated with these factors – particularly those touching on discretion, heterogeneity and comparability – would be greatly appreciated from a financial stability viewpoint.

In the overall picture of the benefits brought by the entry into force of the ECL approach in IFRS 9, the ESRB would like to highlight the following two points.

First, according to data from the European Banking Authority (EBA) Risk Dashboard, in aggregate 9.1% of EU banks’ loans and advances were recognised in stage 2, which amounts to approximately €1.8 trillion. With a coverage ratio of 3.9%, EU banks have already recognised

around €72 billion as ECLs from these exposures in stage 2. Similarly, ECLs from exposures in stage 1 amount to €36 billion. As the coverage ratio for non-performing loans (stage 3 loans under IFRS 9) has remained mostly unchanged compared with that of IAS 39, the recognition of these credit losses for stages 1 and 2 represents an improvement in terms of earlier loss recognition and could be interpreted as having created a cushion that can be used by banks in case the related loans default during a downturn.  

Second, the entry into force of IFRS 9 has also led to a significant effort by banks to upgrade their data infrastructure and their internal governance processes to meet the requirements in the standard. Even if the set-up costs and the ongoing maintenance costs of the models and databases are not negligible, the gains in terms of improved quality of information and decision-making regarding credit risk are significant. These gains benefit not only each individual bank, but also the banking system as a whole.

**Question 3 – Determining significant increases in credit risk**

The application of the concept of a significant increase of credit risk essentially ensures that the financial stability benefits are effectively reaped. This is a point repeated by the ESRB in its published reports. In 2017, the ESRB noted that "the shift of exposures from stage 1 to stage 2 (or vice versa) is critically dependent on the practical implementation of the concept of ‘significant deterioration in credit risk’". Under the current IFRS 9, banks can exercise a certain degree of discretion in applying the significant-increase-in-credit-risk criterion, which marks the transfer of assets from stage 1 to stage 2. In 2019, the ESRB stated that "Given a range of possible definitions for the ‘significant increase in credit risk’, higher (i.e. less conservative) thresholds would lead to lower impairment charges in normal times and higher charges in anticipation of downturns. Consequently, too high thresholds could hamper the early recognition of credit losses, which IFRS 9 attempts to achieve. Lower (i.e. more conservative) thresholds could result in ‘double-counting’ of expected credit losses that are already reflected in the fair value of the loan at inception, with possible side effects on credit availability and banks’ profitability".

Given its critical role in ensuring a sound implementation of the ECL approach, the ESRB considers that the way the concept of “significance increase in the credit risk” is addressed in IFRS 9 could be enhanced, as explained in the following paragraphs.

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7 According to the EBA Risk Dashboard, the average coverage ratio for non-performing loans was 44.1% between the fourth quarter of 2014 and the fourth quarter of 2017 (i.e. applying IAS 39), and 44.9% from the first quarter of 2018 to the first quarter of 2023 (i.e. applying IFRS 9). Being aware of other factors driving the dynamics of the coverage ratio, such as cyclical economic conditions or a potential shift of bank credit portfolios towards riskier loans, this seems to exclude, in the aggregate, the fact that banks have just moved provisions from their non-performing loans to loans now recognised in stage 1 and stage 2 under IFRS 9.

8 In 2017 the Single Supervisory Mechanism found unsatisfactory results in its "Report on the Thematic Review on effective risk data aggregation and risk reporting".


10 See "The cyclical behaviour of the ECL model in IFRS 9", ESRB, Frankfurt am Main, March 2019.
The European Securities Markets Authority (ESMA) and the EBA have identified a range of practices used by banks to determine when an exposure would move from stage 1 to stage 2, some of which combining absolute and relative thresholds that must be met in order to grant the transfer of the exposure to stage 2.\textsuperscript{11} The EBA has also found that some EU banks automatically apply a quantile approach, which in certain circumstances can lead to higher thresholds for a significant increase in credit risk.\textsuperscript{12} In 2019, the largest UK banks were also applying different methodologies to define the threshold of a significant increase in credit risk, as reported by the Bank of England.\textsuperscript{13} The Single Supervisory Mechanism (SSM) is also monitoring how banks are defining the thresholds for a significant increase in credit risk.\textsuperscript{14}

Furthermore, during the coronavirus (COVID-19) pandemic, banks in the sample of EBA analysis generally did not use a collective assessment for a significant increase in credit risk.\textsuperscript{15} In these circumstances, when relevant information on individual exposures was not available, the use of a collective assessment for a significant increase in credit risk would be warranted by the text in IFRS 9 and could have implied significant transfers of exposures to stage 2 (which subsequently would have been reversed, when the uncertainty about the impact of the COVID-19 pandemic receded). Having some, but not all, banks applying the top-down approach at a time when individual information was not available represents an inconsistent implementation of the requirements in IFRS 9. Furthermore, the lack of adequate disclosures on this decision by a large number of EU banks hampered the provision of relevant information to users of financial statements at a time when uncertainty was particularly high.

The use of manual adjustments and management overlays in the assessment of a significant increase in credit risk raises some issues as well. During the COVID-19 pandemic, the EBA observed that (i) pre-pandemic overlays were still being used, raising questions about their temporary nature, and (ii) few of these overlays resulted in a transfer from stage 1 to stage 2, implying that most of them were used to maintain exposures in stage 1.\textsuperscript{16} The permanent implicit nature of overlays and their asymmetric impact on the allocation of exposures across stages are relevant issues moving forward in the implementation of the ECL approach of IFRS 9.

On these grounds and in order to avoid a delayed transfer of exposures to stage 2 (and thus to avoid the risk of a late recognition of credit losses), more guidance is needed on the thresholds to be used in the assessment of a significant increase in credit risk. In particular, this guidance should touch upon:


\textsuperscript{13} See "Thematic feedback from the 2021/2022 round of written auditor reporting", Bank of England, London, 11 October 2022. Similar findings by Deloitte can be found at "After the first year of IFRS 9 – Analysis of the initial impact on the large UK banks", July 2019.

\textsuperscript{14} See "SSM thematic review on IFRS 9 – Assessment of institutions’ preparedness for the implementation of IFRS 9", ECB, Frankfurt am Main, November 2017, and "IFRS 9: credit institutions’ progress with implementation", ECB, Frankfurt am Main, 2018.


• the circumstances, if any, where an automatic quantile approach should or should not be allowed for assessing a significant increase in credit risk, and the relevant disclosures to be made by banks using them;

• the collective assessment of a significant increase in credit risk, in particular in cases where the necessary information at individual level does not exist, including better and more comprehensive disclosures;

• the use of overlays to modify the outcome of the assessment of a significant increase in credit risk, highlighting their temporary nature and the expectation that they should not lead to asymmetric outcomes in terms of stage allocation.

**Question 4 – Measuring expected credit losses**

Regarding the estimation of ECLs, the ESRB would like to comment on two aspects: the use of management adjustments and overlays and forward-looking scenarios.

Starting with management adjustments and overlays, they can be understood as exceptional interventions in model-based calculations of ECLs, according to IFRS 9. They comprise in and post-model adjustments and may be necessary to compensate for the lack of historical data. These data are needed for the modelling of sudden and previously unobserved novel risk factors, which are not adequately captured in the ordinary ECL models. However, as noted by the ESRB in 2019, “the introduction of new modelling requirements and related complexity, coupled with the greater degree of discretion allowed by IFRS 9, may lead to a perception of reduced transparency, inhibit the comparability of disclosures and interfere with market discipline in risk-taking”.17

The COVID-19 pandemic provided a context where overlays could be justified. During that period, banks were faced with the challenge of estimating the extent of the possible economic decline resulting from lockdowns and the associated loan losses in their portfolios. The extraordinary extent of government support measures complicated the assessment of credit risks further. This uncertainty in an unprecedented economic environment could only be partially captured using the ECL models, since there was no robust data history for comparable events regarding central input model parameters such as probability of default (PD) and loss given default (LGD). In its analysis, the EBA found that there was a significant increase in the use of overlays during 2020.18 Interestingly, the EBA added that the COVID-19 pandemic was not the only factor justifying these overlays, pointing to structural issues behind banks’ ECL models. Indeed, it seems that the need for overlays will remain in the future, for example to capture more recent geopolitical and macroeconomic developments such as inflation, the Russian invasion of Ukraine and the energy crisis.

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Furthermore, the methodology and procedures for the computation of overlays are heterogeneous in practice. As reported by the EBA in 2021, they are occasionally based on stress tests for vulnerable sectors, simulations and sensitivity analysis or cumulative rating downgrades for segments that are particularly affected. However, some banks still use expert judgment to cover novel risk factors. The SSM found the latter to be the case in its thematic review of IFRS 9 provisions. It also found evidence that the use of overlays “at total ECL level” (based on judgement) is associated with lower coverage ratios and conflicts with the principles of IFRS 9, according to which banks have to capture all identifiable risks for stage transfers. To this extent, the SSM’s supervisory expectation is that banks either assign risks to specific PDs or LGDs or they complement their overlays at the level of total ECLs with methodologies for a collective assessment of a significant increase in credit risk.

On the basis of their past and expected future use and of the heterogeneity in the methodologies applied by banks to compute them, the ESRB considers that there is a need for more guidance on management adjustments and overlays, including certain rule-based specifications for their application. In more concrete terms, (i) a definition of “overlays” and “post-model adjustments” should be included in the standard, accompanied by practical examples, (ii) disclosures should be added on the impact of overlays and post-model adjustments in the transfers of exposures across stages, and (iii) guidance should be issued on the level of application of overlays and post-model adjustments.

Turning to forward-looking scenarios, in 2019 the ESRB considered that “banks may lack adequate incentives to recognise additional impairments in normal times and may give excessive weight to the baseline scenario. […] Excessive reliance on baseline scenarios could hamper the forecasting power of ECL models and the financial stability benefits of ECL approaches”. To fully reap the financial stability benefits of the ECL approach in IFRS 9, the ability of banks to define several plausible macroeconomic scenarios and regularly update these scenarios is crucial.

However, in the first years of IFRS 9 implementation, variability in the weights attributed to tail scenarios has been observed. According to ESMA, banks in its sample attribute weights of between 1% and 40% to the most optimistic and pessimistic scenarios. The baseline scenario tends to receive weights of above 50% by the majority of banks considered by ESMA in its analysis. Combined with the fact that banks typically use three scenarios, this implies that the baseline scenario generally determines the largest part of the final outcome in terms of ECLs.

Furthermore, heterogeneity has also been found in banks’ approaches to the different scenarios taken into consideration, in particular regarding issues such as the length of the forecast period.

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(from one to five years), the severity of stress, the data sources used (mostly internal, but also from central banks) and the use of different modelling techniques, like Monte Carlo models. The analysis prepared by ESMA in 2021 contains relevant information on these issues.24

In the context of the COVID-19 pandemic, ESMA’s analysis found that banks mainly adjusted their existing scenarios or changed the weights attributed to the optimistic and/or pessimistic scenarios. The EBA noted that some banks introduced certain practices that, in their view, were aimed at avoiding excessive variability in the IFRS 9 estimates, but which could lead in turn to either more through-the-cycle ECL estimates compared with the expectations from IFRS 9 or a minimised impact on the ECL estimation stemming from the non-linearity in the IFRS 9 macroeconomic scenarios.25

While the use of multiple scenarios is theoretically appealing, the practical implementation of this requirement in IFRS 9 reflects a high reliance on the baseline scenario for the computation of ECLs and a range of scenarios and weightings applied by reporting entities.

As an alternative to the use of multiple scenarios and given the limited impact of the tail scenarios compared with the baseline scenario, the case could be made for the estimation of ECLs to be based on a single scenario, possibly supplemented by the results of detailed sensitivity analyses for each key variable in the notes to the financial statements.26 However, that solution would not be optimal from a financial stability perspective because, as noted by the ESRB in 2019: “Financial stability, in general, and macroprudential policy, in particular, are typically focused on tail events, which are, by definition, not covered in baseline scenarios. Baseline scenarios have typically performed poorly at anticipating future downturns, as these are situations which emerge out of the expected path of the economy […]. Therefore, if the ECL models are expected to be relevant in their degree of anticipation of future downturns, it is necessary that they do not rely mostly on the baseline scenario and that other (non-baseline) scenarios are considered and objectively weighted in the final outcome”.27

On these grounds, maintaining several scenarios as a requirement of IFRS 9 seems desirable from a financial stability perspective. However, the ESRB considers that more guidance should be included in IFRS 9 on the use of macroeconomic scenarios (for the purpose of ECL estimation and sensitivity analysis), including, but not limited to, the time horizon of the scenario, the use of economic forecasts by central banks or international organisations, the expectations in terms of weights of the different scenarios, and the approaches to revert to long-term averages beyond the period for which banks prepare detailed forecasts of macroeconomic conditions.

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26 The results of the sensitivity analysis could result in an overlay of the amount of expected credit losses derived from the macroeconomic model. From that point of view, a properly calibrated sensitivity analysis could theoretically be seen as equivalent to having multiple scenarios.

Question 9 – Credit risk disclosures

Having sound and effective disclosures improves the transparency of the information provided to market participants and accordingly has financial stability benefits. Already in 2017, the ESRB noted that “Extensive and high-quality disclosures will play an essential role in allowing users, auditors and supervisors to understand the modelling assumptions behind the reported impairment allowances. [...] Adequate disclosures are crucial to ensuring that IFRS 9 is adequately implemented.” The 2019 ESRB report added that “Notwithstanding the enhanced disclosure requirements of IFRS 7, in the absence of any initiatives in this area, users of financial statements may find an increase in the complexity and a decrease of the comparability of existing disclosures.” The analysis by ESMA in 2021 also highlights the importance of disclosures for a sound implementation of the ECL approach in IFRS 9.

The ESRB agrees with the consideration made in Spotlight 9 of the request for information, calling on the IASB to add minimum disclosure requirements, specify the format of some disclosures and add particular illustrative examples to IFRS 7. Disclosures on the exposures subject to a significant increase in credit risk and on management adjustments and overlays would be particularly relevant in this regard. In addition, two further elements of disclosure where additional guidance and illustrative examples could be provided are (i) a reconciliation between ECLs at the beginning and at the end of the reporting period, and (ii) a matrix showing the transfers of exposures across stages during the reporting period.

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28 See Figure 1 and the following paragraphs in “Financial stability implications of IFRS 17 Insurance Contracts”, ESRB, Frankfurt am Main, December 2021.