

IFRS 9 response to COVID-19

Maintaining robust and controlled expected credit losses during the COVID-19 crisis

April 2020



COVID-19 has significantly impacted the manner in which banks' expected credit loss (ECL) models under IFRS 9 *Financial Instruments* perform in less than benign economic circumstances

1 Immediate priorities

1. Incorporating the impact of government relief measures into ECL results
2. Determining reasonable and supportable macro-economic assumptions
3. Reliable estimates of the ECL impact considering the use of management overlays
4. Undertaking robust sensitivity analysis to support key assumptions and judgments
5. Maintaining strong governance over entire ECL estimation process and key controls
6. Consider challenges from resourcing constraints and potential disruptions to operational processes

2 Longer-term considerations

1. Modelling "pandemic" specific data (e.g., defaults time series, downturn definition)
2. Stronger integration across risk management "early warning indicators" and IFRS 9 triggers
3. Macro-economic "crisis" scenario capabilities and simulation models
4. Model changes required to reflect increased default rates and changes to recovery approaches
5. Enhanced monitoring controls to mitigate risks due to remote-working
6. Changes to risk appetite framework, credit approval and limit management processes, etc.

EY modelling insights*

- ▶ Majority of banks have defined specific COVID-19 scenarios for IFRS 9. There is variation in the approach taken to quantify the impact of COVID-19 on Q1 results, with the majority of banks using portfolio level overlays
- ▶ Many banks have revised the probability weightings applied to the economic scenarios in Q1
- ▶ Some banks are capturing stage movements through management overlays while others are taking a "top down" approach by transferring part or all of the most impacted portfolios to Stage 2. A large number of banks remain undecided
- ▶ Banks are also evaluating enhancements to credit risk monitoring measures (e.g., forbearance, watchlist) in response to recent regulatory requests for this data

Governance matters

- ▶ Engage up-front on modelling and policy changes which may undergo changes in the immediate future
- ▶ Consider the operational impact across data, systems and controls of any changes to the current IFRS 9 operating model
- ▶ Determine the need for additional governance around significant judgements, modelling changes and other changes in the IFRS 9 processes and controls

*Based on the results of an EY COVID-19 benchmarking survey undertaken across select global Banks (March 2020)

In these unprecedented circumstances, it is critical to have the modelling capabilities to undertake scenario analysis and understand the impact under varying assumptions.

Macro-economic scenarios and management overlays	<ul style="list-style-type: none"> ▶ Integrate epidemiological scenarios and overlay macro-economic scenarios with pandemic outcomes ▶ Capability to model variations in macro-economic scenarios simultaneously
Forbearance	<ul style="list-style-type: none"> ▶ Consideration of whether normal forbearance measures will be granted ▶ Operational processing of forbearance claims in light of other COVID-19 measures being granted ▶ System capability to monitor forbearance measures separate from COVID-19 measures to track customers which may have deteriorated without COVID-19
Probability of Default (PD) modelling	<ul style="list-style-type: none"> ▶ Distinguish technical default events due to impacts from government relief measures from actual defaults in PD models ▶ Filter the impact of double hit - some PD models may react very quickly due to internal account behavior variables and yet the bank still estimates an overlay ▶ Consider the impact of government initiatives to support select sectors or borrowers
Extension of payment terms and other relief measures granted to borrowers	<ul style="list-style-type: none"> ▶ Terms and conditions of extension payment terms to be assessed to determine their impacts on the ECL estimate as well as any other accounting impacts ▶ Application of extensions and other government relief measures to the underlying loan population will require judgement and credit expert insights
Impacts on Exposure at Default (EAD) and Loss given Default (LGD)	<ul style="list-style-type: none"> ▶ Effect of credit enhancements on the LGD will have to be revised to reflect the impact of updated values of collateral and guarantees, including the effect of government relief ▶ EAD estimate will need to be updated, mainly for loan commitments and other types of credit facilities where a deterioration of the
Re-segmentation of loan portfolios or groups or receivables	<ul style="list-style-type: none"> ▶ Change the risk characteristics of certain loans or receivables due to a change in the nature of business undertaken or business relocations ▶ Need to consider (re)segmenting (sub)portfolios based on revised risk characteristics
Individual and collective assessment of loans, receivables and contract assets	<ul style="list-style-type: none"> ▶ Delays in detection of actual changes in risk indicators for a specific counterparty ▶ Accelerate impact of such changes in credit quality not yet detected at an individual level, by adjusting ratings and the PD on a collective basis
Process and controls	<ul style="list-style-type: none"> ▶ Changes, due to the above points, to current automated processes to manual "work-arounds" will introduce more risks and require enhancements to the existing controls ▶ Additional operational risks from remote-working may also require enhanced controls in the interim period

IFRS 9 Regulatory and Standard Setter updates

The European Central Bank, European Banking Authority, European Securities and Markets Authority, Bank for International Settlements, UK Prudential Regulation Authority and the International Accounting Standards Board, have all issued statements emphasizing the need to make a well-balanced ECL assessment in accordance with the accounting principles of IFRS 9 and Prudential regulations.

The views expressed are largely consistent and include emphasis on the limited availability of reliable forward-looking information, consideration for the significant government relief efforts and the fact that the payment moratoria offered irrespective of the borrowers' individual circumstances should not be generally seen as an indicator of significant increase in credit risk.

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EY tools and thought leadership

EY Spotlight is a quantitative analytics tool that provides real-time updates on the status of COVID-19 globally, macro-economic impacts and regulatory updates. The EY Spotlight tool also has the capability to simulate the impact of COVID-19 on loan losses, taking into account deterioration of credit quality and relief measures.



EY has recently issued a series of publications to assist clients in understanding the impact on the accounting practices due to the COVID-19 pandemic.

- ▶ IFRS Developments (March 2020) - IASB and regulators highlight IFRS 9 ECL requirements during the Coronavirus pandemic
- ▶ Applying IFRS Accounting Considerations of the coronavirus outbreak (March 2020)



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