



## **IFRS 9 expected credit loss**

Making sense of the  
transition impact



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# IFRS 9 expected credit loss: making sense of the transition impact

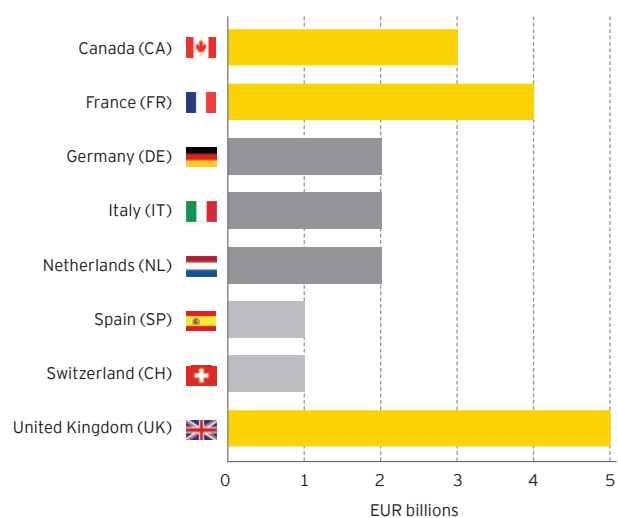
For banks reporting under International Financial Reporting Standards (IFRS), 1 January 2018 marked the transition to the IFRS 9<sup>1</sup> expected credit loss (ECL) model, a new era for impairment allowances.

The road to implementation has been long and challenges remain. EY supported banks throughout the implementation journey with a series of annual surveys that provided 'state of readiness' benchmarks and implementation trends<sup>2</sup>.

This publication complements the series of surveys with a quantitative analysis of the transition to ECL in terms of impact on the financial statements<sup>3</sup> and Core Equity Tier 1 ratio (CET1 ratio). Beyond the change in numbers, it discusses the main factors that explain differences between banks and countries.

The analysis was conducted on a sample of large banks representing continental Europe, the UK and Canada. Although presented on an anonymous basis, it is entirely based on publicly available information, such as 2017 annual reports, IFRS 9 transition reports and Q1 2018 quarterly reports.

**Figure 1: Sample of banks, by country**



## Executive summary

The transition to IFRS 9 generally resulted in an increase in impairment allowances. The impacts on financial statements and CET1 ratio are, in most cases, lower than previously estimated, reflecting in part more favourable economic conditions.

With a few exceptions, allowances for credit-impaired loans remained fairly stable compared with IAS 39, which already required estimation of lifetime expected losses for these exposures. For non-impaired loans, ECL allowances are generally higher than IAS 39 collective allowances. Significant differences in transition impacts appear between banks, including at the country level. Many of the factors that explain

these differences are typical drivers of changes in impairment, such as the bank size, its portfolio mix and geographical footprint. Transition impacts also reflect different judgements and estimates in terms of ECL methodological choices and forward-looking scenarios. In addition, several factors not related to the ECL approach had a significant impact on transition, such as reclassifications, write-off policies, and the treatment of purchased and originated credit-impaired (POCI) loans.

These drivers and their complex interactions illustrate some of the challenges ahead for banks in explaining changes in allowances and for financial statements users in understanding them.

<sup>1</sup> IFRS 9 *Financial Instruments*

<sup>2</sup> EY IFRS 9 Impairment Banking surveys 2015-2018.

<sup>3</sup> This analysis is focused on ECL allowances for loans. Exposures resulting from cash in bank accounts, securities, guarantees and credit commitments were excluded whenever they were disclosed separately.

# Main features of the ECL model

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Under IAS 39, impairment allowances were measured according to an 'incurred' loss model wherein the recognition of credit loss allowances was triggered by loss events subsequent to origination. Losses 'incurred but not reported' were evaluated using diverse provisioning approaches, varying between banks and countries.

The new IFRS 9 impairment model requires impairment allowances for all exposures from the time a loan is originated, based on the deterioration of credit risk since initial recognition. If the credit risk has not increased significantly (Stage 1), IFRS 9 requires allowances based on 12 month expected losses. If the credit risk has increased significantly (Stage 2) and if the loan is 'credit-impaired' (Stage 3), the standard requires allowances based on lifetime expected losses.

The assessment of whether a loan has experienced a significant increase in credit risk varies by product and risk segment. It requires use of quantitative criteria and experienced credit risk judgement.

As opposed to IAS 39 which required a best estimate approach, IFRS 9 requires multiple forward-looking macro-economic and workout scenarios for the estimation of expected credit losses.

## US GAAP perspective

The US Financial Accounting Standards Board (FASB) published a new impairment standard<sup>4</sup> based on 'current expected credit losses' (CECL) in 2016, which significantly changes accounting for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The earliest effective date is the beginning of 2020 for calendar-year entities that meet the definition of a public business entity. Early adoption is permitted for all entities beginning in 2019.

Similar to IFRS 9, the FASB's model is forward-looking, no longer requires a 'trigger event' for the recognition of impairment allowances and should be based on reasonable and supportable information.

The two standards differ the most in terms of the period over which losses are measured and recognised. The FASB's model requires measurement of lifetime ECL from the time of loan origination. Compared to IFRS 9 'staged' approach, this leads to a higher expected impact on transition to CECL.



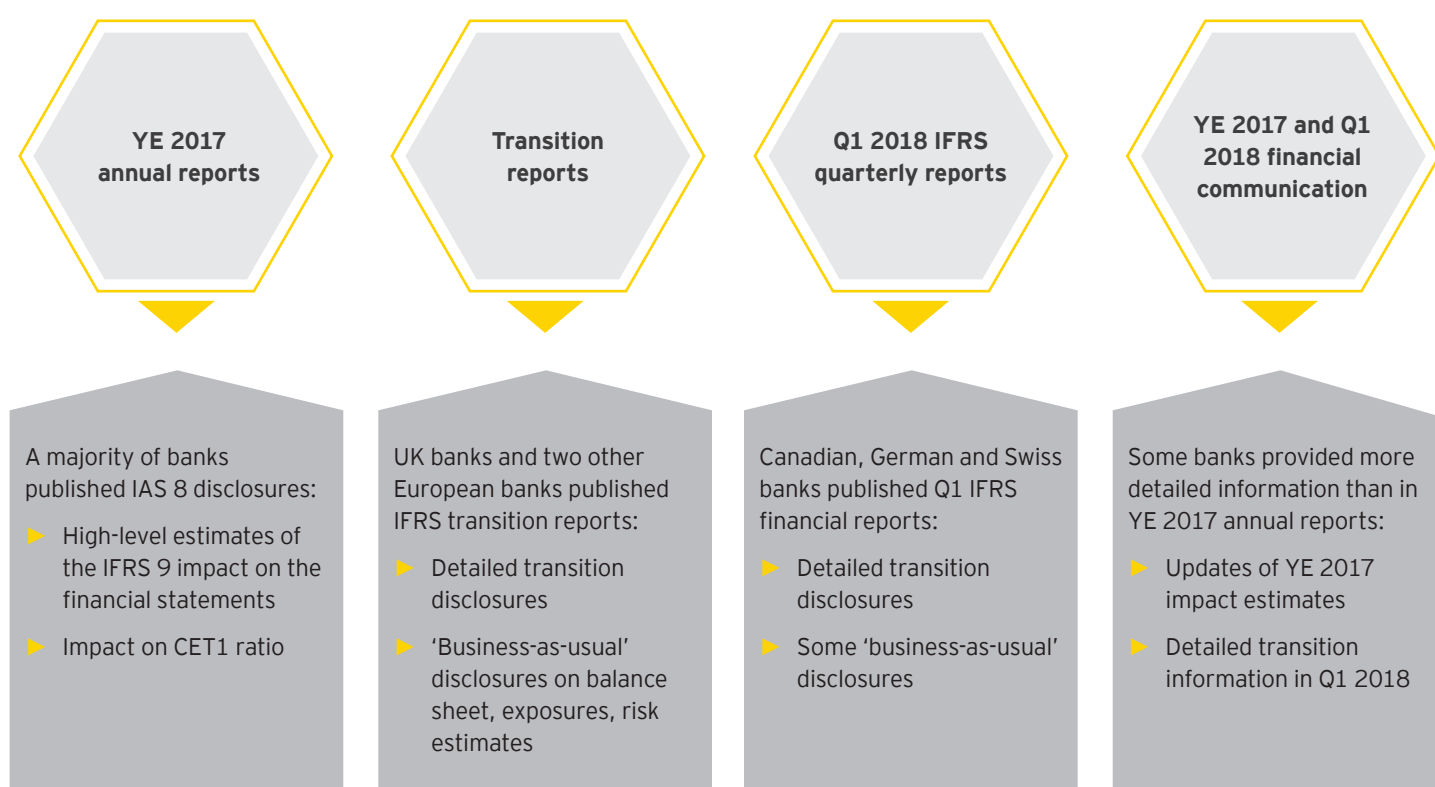
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<sup>4</sup> Accounting Standards Update 2016-13, Financial Instruments – Credit Losses (Topic 326), *Measurement of Credit Losses on Financial Instruments*.

# Availability and granularity of ECL disclosures

While several sources of information currently provide insights on the IFRS 9 impact on loan provisions, their granularity and level of detail vary, in some instances due to country-specific requirements.

**Figure 2: Sources of ECL information**



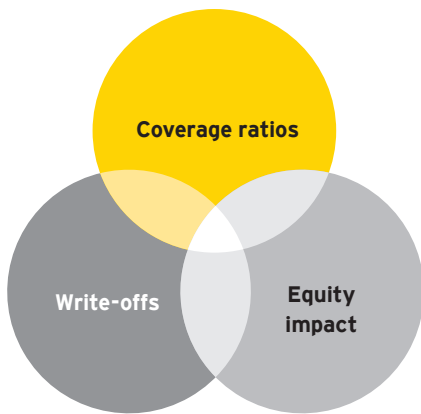
The first ECL disclosures provided in year-end (YE) 2017 annual reports were high-level estimates of the increase in loan allowances and impact on CET1 ratio. In the UK, shortly after the yearend, banks published IFRS 9 'transition reports', a comprehensive set of accounting and regulatory disclosures. These reports explain the impact of IFRS 9 on classification, measurement and loan allowances, and include 'deep dives' on exposures and provisions by stage, business line and product. Besides UK banks, two other European banks published transition reports on a voluntary basis.

Some banks in the sample, such as Canadian, German and Swiss banks have published Q1 IFRS accounts, which include full IFRS 9 transition disclosures and most 'business-as-usual' disclosures, including breakdowns of exposures and ECL allowances per stage, as well as changes in ECL allowances over the quarter.

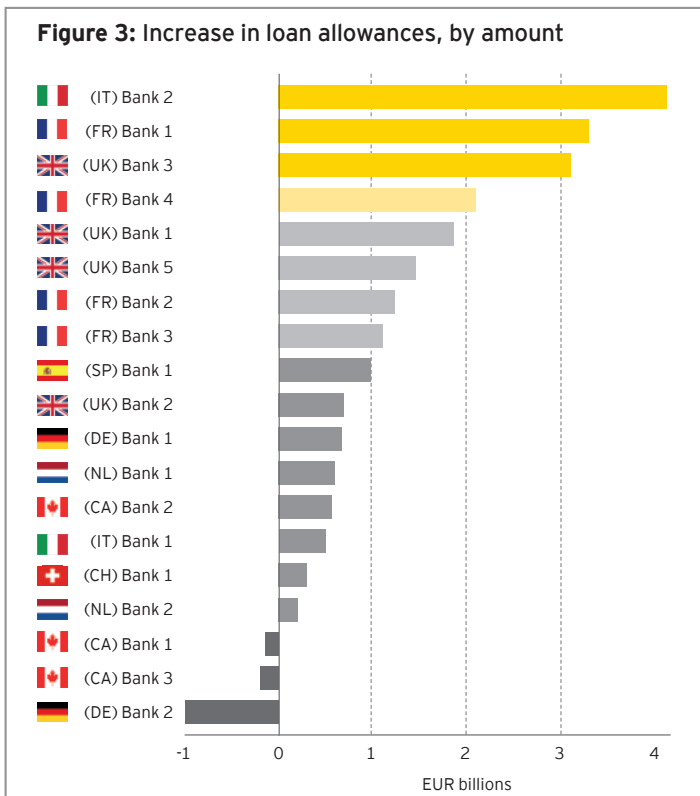
At the time of writing, some banks in the sample had solely provided revised impact estimates and limited transition information in their Q1 financial communication and as a result, are not included in some of the figures presented in this analysis.

# Overall ECL transition impact

This transition impact analysis is focussed on some of the key indicators that we expect financial statement stakeholders will use to compare banks under IFRS 9, such as the level of provisions, coverage ratios and equity impact upon transition.



For the majority of banks analysed, the transition to IFRS 9 generally results in an increase in allowances, ranging from a few millions to EUR4 billion (Figure 3).



Bank size is a significant contributor to the magnitude of the increase in loan allowances (Figure 4). However, there are notable exceptions. Some point to the multitude of factors that typically trigger changes in loan provisions, such as the bank's product mix and its geographical footprint. Others include regional trends in IAS 39 provisioning practices and differences in the significant judgements involved in the ECL methodology.

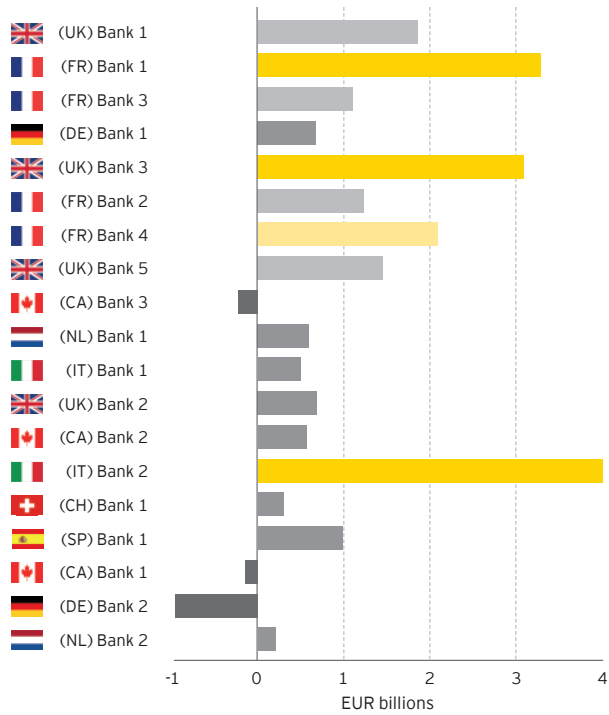
- ▶ **Portfolio mix:** Generally, retail portfolios experienced larger increases in loan provisions. For credit cards in particular, the impact is significant for some banks, as a consequence of longer expected lives for deteriorated exposures varying from two to nine years.
- ▶ **Stage 3 loans (impaired loans):** For some banks, the use of multiple workout scenarios for impaired loans is another noteworthy factor driving the increase in provisions
- ▶ **Significant judgments and estimates:** It is well known that IFRS 9 ECL guidance leaves room for judgement on key concepts such as whether there has been a significant increase in credit risk, measurement of lifetime expected credit losses and forward-looking assumptions. Differences in key judgements and estimates between banks undeniably explain some of the differences observed. More detailed disclosures and sensitivity analyses would be helpful to financial statements users in these areas.

- ▶ **IAS 39 provisioning practices:** How banks applied IAS 39 is also a key driver for of the change in allowances reflected by the impact on the 'good' book (i.e., on provisions for Stage 1 and Stage 2 loans under IFRS 9).

Financial statement disclosures reflect several significant factors not directly linked to the expected loss measurement approach that partially offset the expected increase in allowances on transition:

- ▶ **Reclassifications:** Decreases in the impairment allowance on transition are in some cases explained by reclassifications of loans from amortised cost to fair value through profit or loss (FVTPL), for which there is no allowance.
- ▶ **Write-off policies:** For some banks, changes in write-off policies implemented simultaneously with IFRS 9 reduced the overall increase in allowances upon transition. Some impaired loans were fully or partially derecognised, resulting in a decrease in gross loans balances and related impairment allowances.
- ▶ **Purchased and originated credit impaired (POCI) loans:** For some banks, loans deemed POCI on transition also led to a decrease in the impairment allowance, expected credit losses being included in the carrying amount for these assets.

**Figure 4: Increase in loan allowances, by bank size**



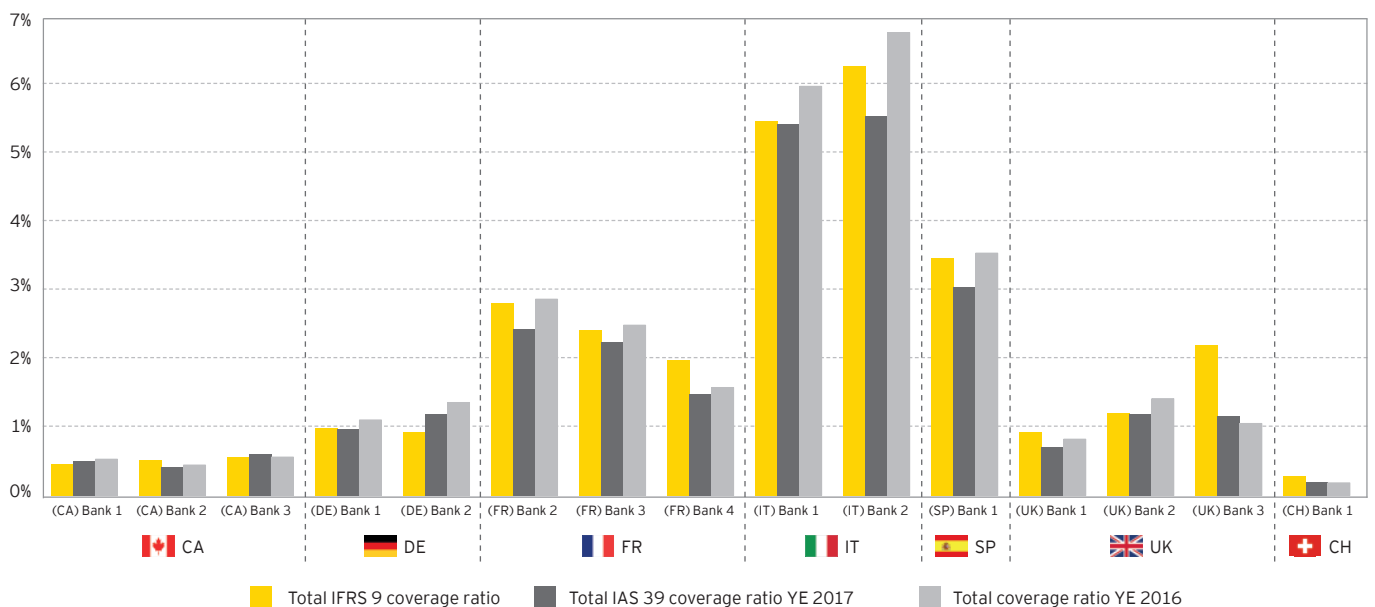
These factors and their interactions illustrate some of the challenges banks faced in providing comparable and comprehensive IFRS 9 transition disclosures, while distinguishing between the impact of the ECL approach and related judgements and those resulting from reclassifications, changes in write-off policies and POCI.

These changes need to be evaluated to comprehend the impact of the ECL transition on total coverage ratios, which we further discuss below.

From 2016 to 2017, total coverage ratios under IAS 39 decreased, likely reflecting improving macro-economic conditions, followed by an increase on transition to IFRS 9 (Figure 5). The impact on total coverage ratios ranges from -5 bps to approximately 40 bps, with a couple of exceptions, notably for UK Bank 3 (a 100 bps increase, mainly due to increased impairment allowances on credit cards), Italian Bank 2 (a 70 bps increase, due to the incorporation of sale strategies in Stage 3 impairment allowances).

Changes in write-off policies leading to earlier write-offs explain why some banks (such as Italian Bank 1) did not experience a higher increase in coverage ratios. These changes are further explained in the section related to credit-impaired loans.

**Figure 5: Total coverage ratios<sup>5</sup>**

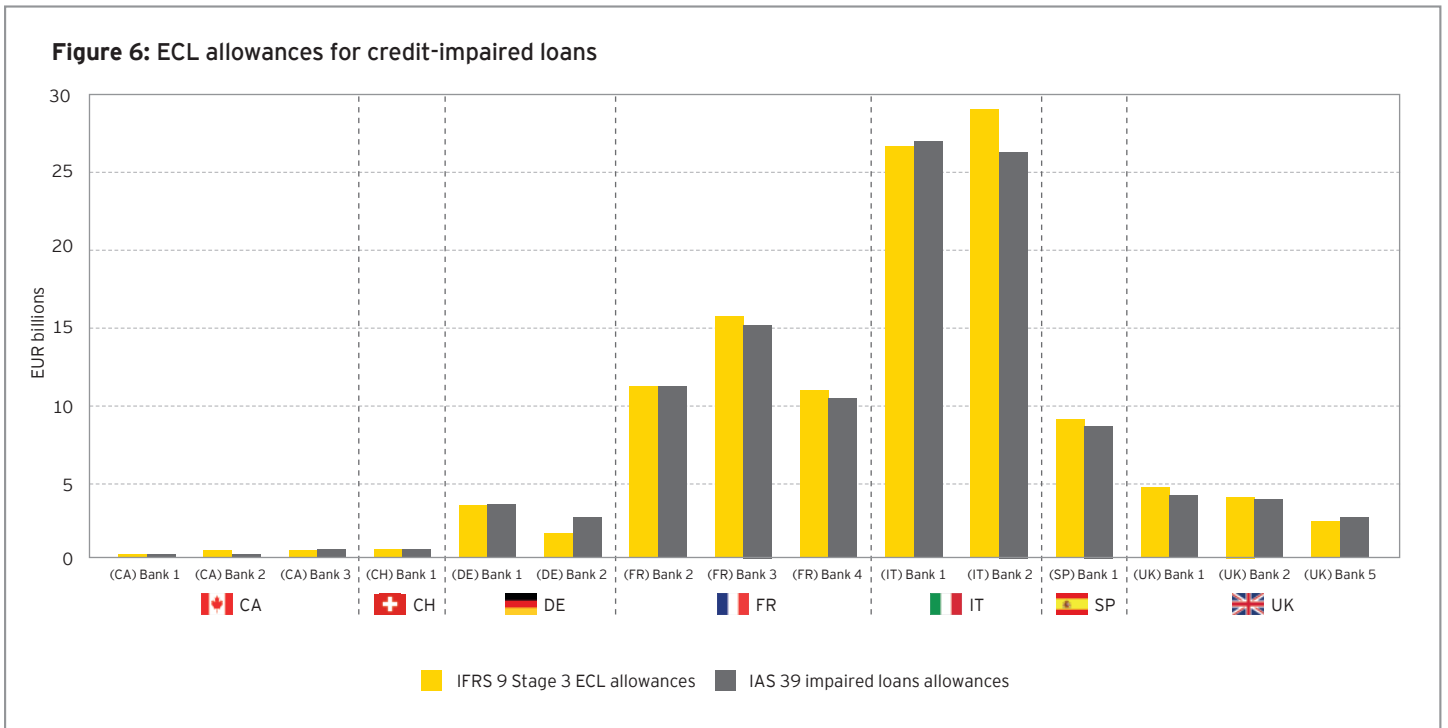


<sup>5</sup> Total coverage ratio: the numerators are respectively the IAS 39 total loan loss allowance and the IFRS 9 total ECL allowance, and the denominators are gross loan balances excluding cash, securities and off-balance sheet exposures.

# ECL transition impact for credit-impaired loans

The majority of banks have aligned the accounting definitions of default and credit-impaired loans with the regulatory definition of default. With a few exceptions, allowances for credit-impaired exposures remained fairly stable compared to IAS 39 which already required estimation of lifetime expected losses for these loans.

Based on UK banks IFRS 9 transition reports, an upward trend is noted for collateralised portfolios, due to the incorporation of multiple forward-looking scenarios upon transition to IFRS 9. Decreases in allowances are in some instances due to the reclassification of impaired loans to fair value through profit or loss (e.g., German Bank 2).



**Recovery estimates:** The IFRS Transition Group for Impairment of Financial Instruments (ITG) confirmed in September 2015 that the cash flows expected from the sale of loans in default should be included in the measurement of expected credit losses. For banks with significant sale plans for non-performing assets, the expected discount in sale prices resulted in a significant decrease

in recovery estimates. The incorporation of sale strategies in provisioning methodologies triggered significant increases in provisions for credit-impaired loans for these banks, such as for ex-ample for Italian Banks 1 and 2. For Italian Bank 1, we note that the impact of recovery estimates was offset by simultaneous write-offs.

<sup>6</sup>The definitions of 'credit-impaired' and "non-performing" loans are not identical.

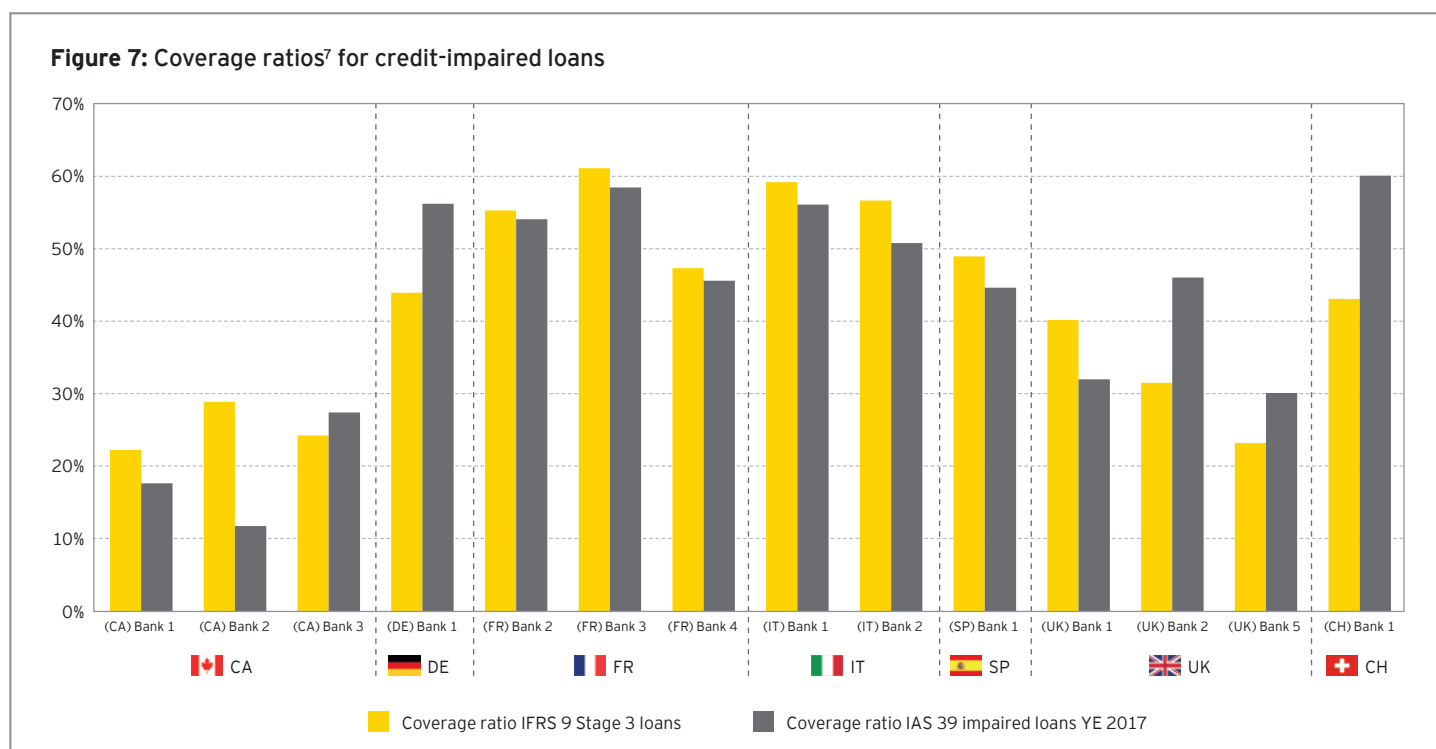


**Write-off policies:** Changes in write-off policies upon transition led some banks to derecognise all or parts of lower-quality, higher coverage ratios loans. This reduced credit-impaired loan balances and their coverage ratios. Major differences in write-off policies between countries and banks significantly reduce the comparability of these exposures. In general, French and Italian banks write-off credit-impaired loans later than UK and Canadian banks, based on local recovery law considerations. New trends may emerge as a consequence of the ECB's focus on reducing non-performing<sup>6</sup> loans, often reported based on gross balances.

**Scope/definition of credit-impaired loans:** A number of banks have changed the scope of credit-impaired loans on transition. These banks classified loans as Stage 3 earlier than they were

classified as 'impaired' under IAS 39, which generally added better-quality, lower-coverage assets to credit-impaired exposures. These increases in the population of credit-impaired loans diluted their coverage ratios. For example, UK Bank 2 states that creditimpaired assets now include assets that have defaulted but for which they expect full recovery.

The impacts on impaired loans coverage ratios (Figure 7) reflect these differences in the definition 'credit-impaired' loans and write-off policies. They vary from bank to bank, from decreases for some banks (e.g., German Bank 1 and UK Bank 2) to low or moderate increases for the majority of banks, and significant increases for two banks (UK Bank 1 and Canadian Bank 2).

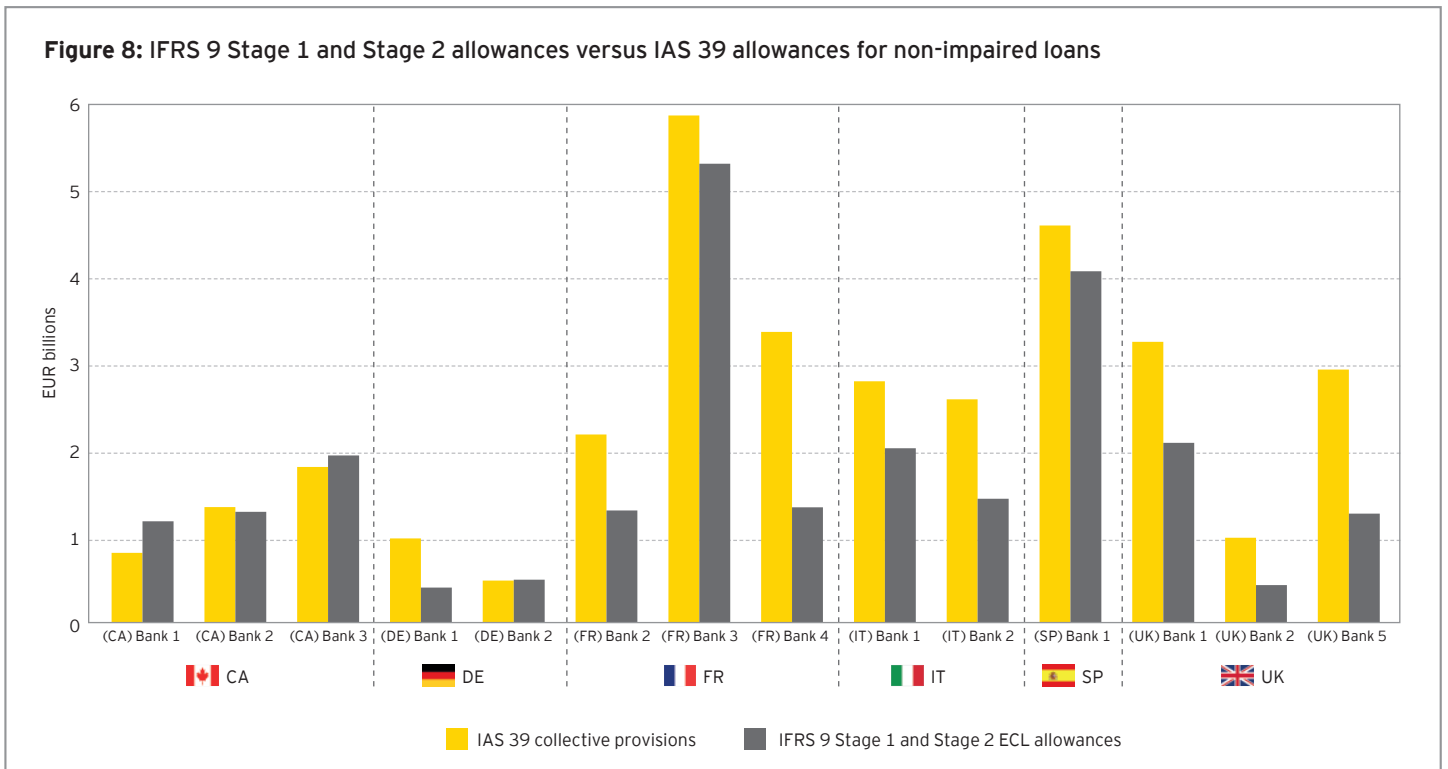


<sup>7</sup> Coverage ratios computation: the numerators are respectively the IAS 39 allowance for credit-impaired loans and the IFRS 9 Stage 3 ECL allowance, and the denominators are respectively the balances of credit-impaired loans under IAS 39 and IFRS 9.

# ECL transition impact for the 'good' book

For non-impaired loans (Stage 1 and Stage 2 under IFRS 9, or the 'good' book), ECL allowances appear consistently higher than the IAS 39 allowances for non-impaired loans, with the exception of those of Canadian banks (Figure 8).

For these exposures, differences in IAS 39 practices and differences related to product mix affected the transition impact, as further discussed below.



- ▶ **IAS 39 provisioning practices:** The level of IAS 39 nonimpaired loans allowances varied significantly from bank to bank due to either country-related, or bank-specific provisioning practices.
- ▶ **'Incurred-But-Not-Reported' (IBNR) approach versus collective allowances for 'deteriorated exposures':** The analysis of IAS 39 provisioning practices shows that banks which calculated 'incurred but not reported' allowances using

emergence periods (e.g., Canadian and UK banks) generally experienced a higher increase for Stage 2 allowances, while the impact on Stage 1 was limited to the difference between the IAS 39 emergence period and the minimum 12M ECL horizon required under IFRS 9. On the contrary, banks which had IAS 39 collective allowances based on deteriorated exposures (e.g., French banks) set up ECL allowances for Stage 1 exposures upon transition and generally experienced a smaller impact on their Stage 2 allowances.

- ▶ **Product mix:** The product mix plays a significant role in the increase in allowances for non-impaired exposures ('good' book), with the following trends observed at product level:
  - ▶ Significant impact on credit cards and unsecured personal lending, which have higher probability of default (PDs) and loss given default (LGDs). The inclusion of undrawn amounts and behavioural lifetimes for Stage 2 allowances were major drivers of the increase in allowance upon transition, particularly in the UK and Canada where these products generally represent a larger share of banks' total exposures.
  - ▶ Some impact on mortgage loans for which IAS 39 non-impaired loans allowances were based on shorter emergence periods, or triggers generally delayed compared to the IFRS 9 Stage 2 triggers. However, the transition impact for mortgage portfolios was low to moderate for the majority of banks, due to lower LGDs and positive real estate trends at the time of transition. Also, in countries such as France or Canada<sup>8</sup>, local credit

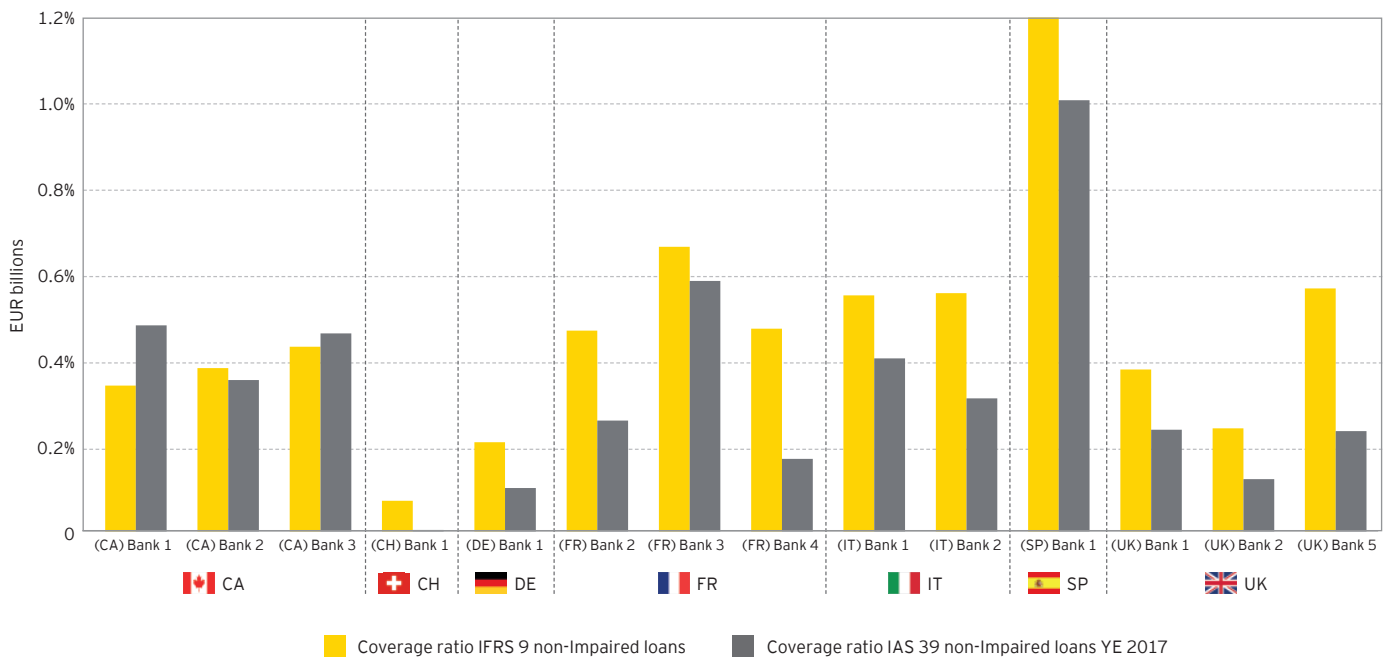
enhancement mechanisms result in lower LGDs as well as a relatively low sensitivity to macroeconomic parameters.

- ▶ Limited impact on wholesale portfolios, for which watch list and sector provisions, or IBNR provisions resulted in relatively high coverage under IAS 39 (e.g., France and Canada). Some banks noted little change, or even a decrease, primarily resulting from the use of relatively long emergence periods under IAS 39.
- ▶ The overall impact on banks with large international portfolios also reflects country-specific product considerations.

Similar to credit-impaired portfolios, the comparison between banks can be slightly distorted by differences in the definition of credit-impaired between banks: the narrower the definition, the bigger the 'good' book allowance, and vice versa.

Overall, the factors discussed above indicate that the analysis of the amount and/or percentage increase upon transition should be supplemented by a review of qualitative disclosures .

**Figure 9: Coverage ratios for non-impaired loans**

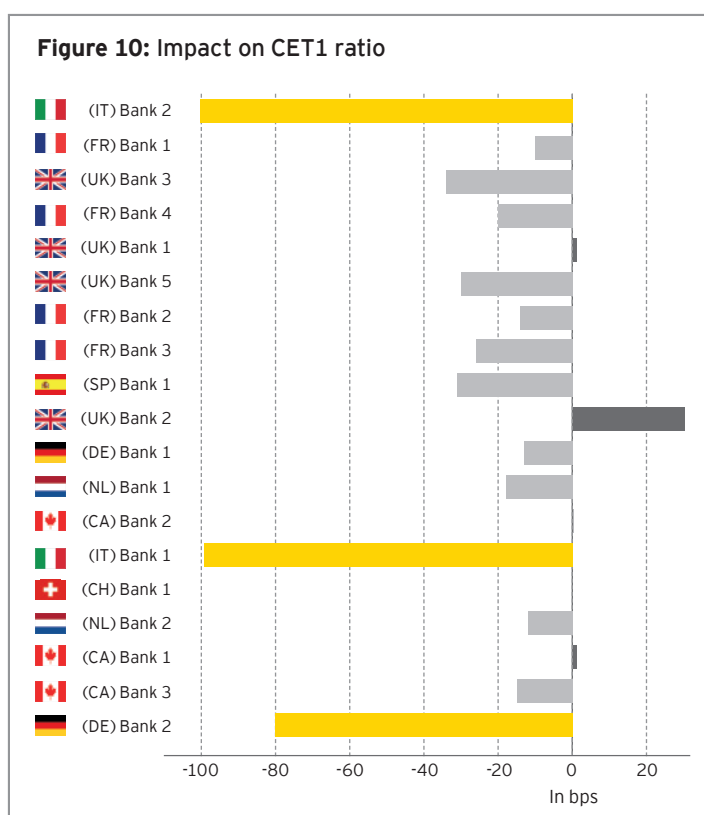


<sup>8</sup> Canada Mortgage Housing Corporation (CMHC) programs in Canada and 'Crédit Logement' in France

# Regulatory impact

The impact on the regulatory CET1 ratio was a key indicator used by banks to quantify the IFRS 9 transition impact in their financial communications.

There are significant differences between the impact on CET1 ratios (Figure 10) and changes in impairment allowances (Figure 3). Note that banks are shown in the same order as in Figure 3 (i.e., from the highest to the lowest change in provision).



## What is driving the differences?

First, the impact on CET1 ratio reflects reclassifications of loans which occurred upon implementation of the new IFRS 9 classification model. Such reclassifications affect IFRS

shareholders' equity on transition when they lead to changes in measurement from amortised cost to fair value and vice versa. In some cases, the positive effects of reclassifications substantially offset the increase in impairment allowances (for example, for UK Banks 1 and 2). In other instances (for example, German Bank 2), they have a negative effect.

Second, the increase in allowances results in deferred tax assets, which lowered the overall impact on IFRS Shareholders Equity and CET1 ratio. Deferred tax assets are subject to a cap, which led to a 'haircut' in the regulatory capital impact for some banks.

For exposures under internal rating based (IRB) approaches, the most important driver of the difference between the accounting impact and regulatory impact is the 'shortfall' of accounting allowances compared with regulatory expected losses, which is deducted from CET1<sup>9</sup>. The amount of the shortfall varied from bank to bank, depending on their provisioning practices and the extent of IRB exposures as a percentage of total exposures. This resulted in different levels of absorption of the IFRS 9 increase in allowances.

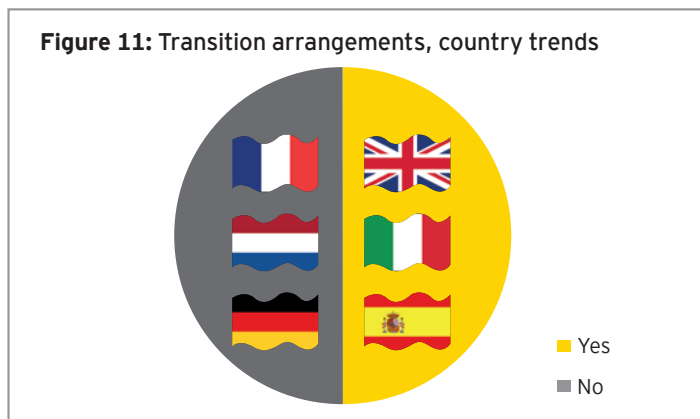
- ▶ This leads to somewhat counter-intuitive results, such as a high impact on CET1 ratios for banks with high coverage ratios. For example, French Bank 3 experienced a high impact on its CET1 ratio due to a limited amount of shortfall available to absorb the increase, compared to other banks which experienced a similar level of increase in allowances.
- ▶ Italian banks had limited or no shortfall to absorb the increase in allowances, partly because their coverage ratios under IAS 39 were already high and partly due to the use of the IRB approach for a relatively lower portion of their exposures. On average, 50% of their exposures are under IRB approaches, compared to more than 70% for other banks included in the sample.

For exposures under the standardised approach, the increase in allowance decreased risk weighted assets. This also reduced the transition impact on CET1 ratios, although to a lower extent than for IRB exposures. For further details, please refer to our publication 'Regulatory impact of accounting provisions'.

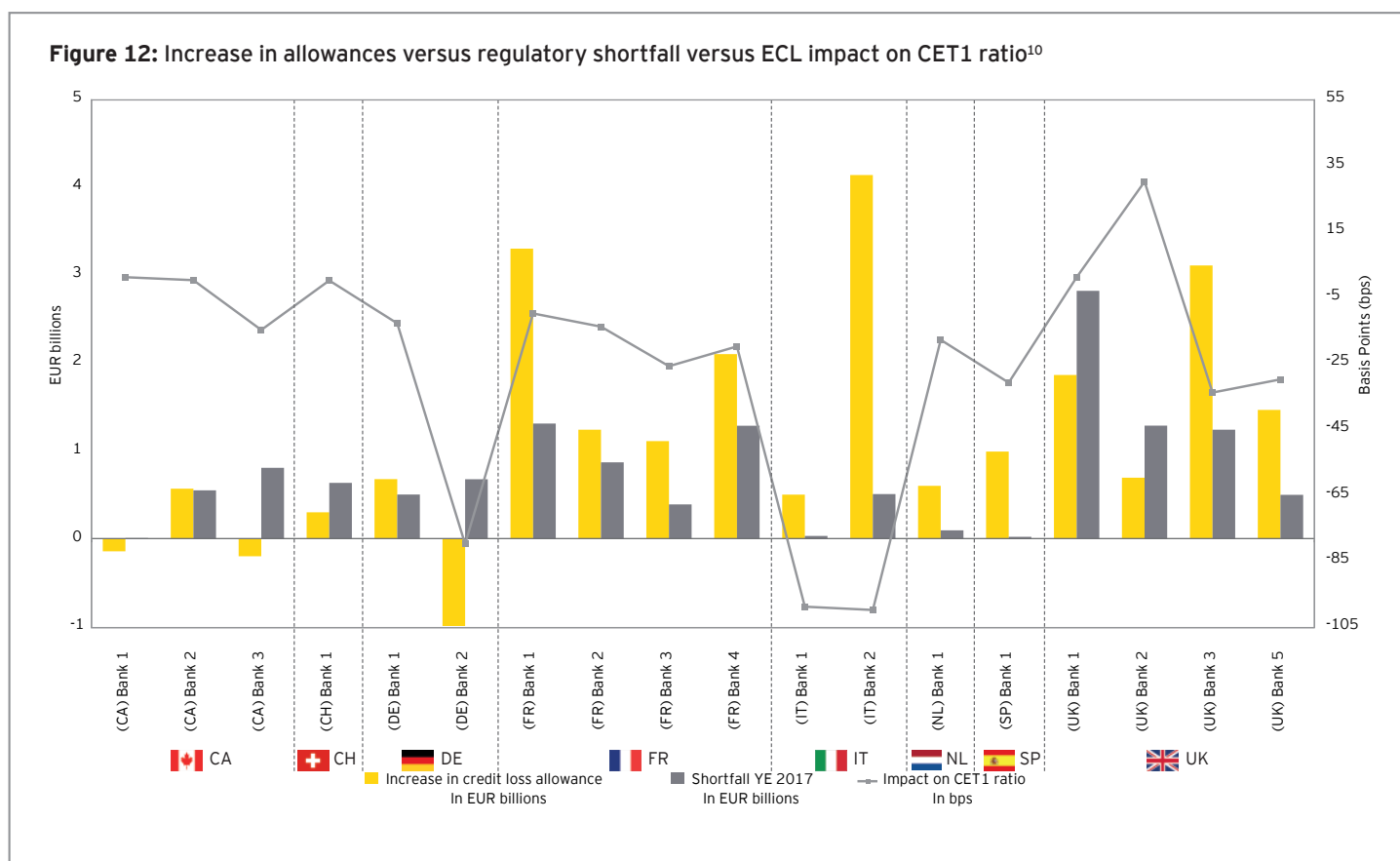
<sup>9</sup> Refer to EY Regulatory Impact of Accounting Provisions for further details.

Finally, European banks have the ability to apply transitional arrangements and spread the impact of IFRS 9 impairment requirements over a 5-year period, with an impact of only 5% in year 1. As reflected Figure 11, the application of these transitional measures varies by country. UK banks and most Spanish and Italian banks elected to apply these measures. French, German and Dutch banks opted for an immediate impact on regulatory capital of ECL transition effects. Some banks which elected to apply the transitional measures experienced an increase in CET1 as a result of reclassifications with positive effects on shareholders' equity.

**Figure 11: Transition arrangements, country trends**



**Figure 12: Increase in allowances versus regulatory shortfall versus ECL impact on CET1 ratio<sup>10</sup>**

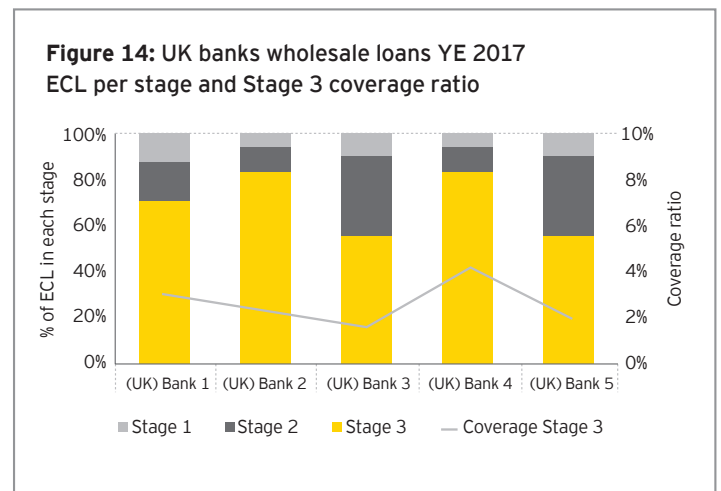
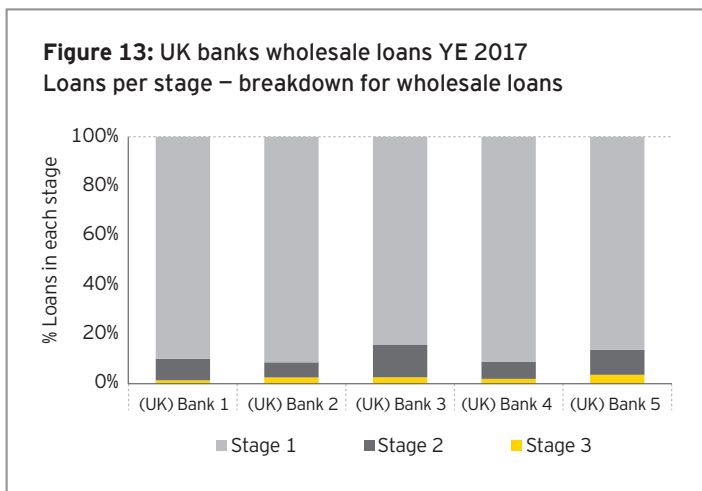


<sup>10</sup> The impact on CET1 ratio was considered on a « fully loaded » basis – i.e., excluding transitional arrangements relief.

# Towards enhanced transparency

The disclosures that became available in the transition reports and some interim accounts reveal a fundamental change in the content and granularity of credit provisioning information. Detailed tables of exposures and ECL allowances by stage, business or product lines and credit quality, as well as coverage ratios by stage allow more detailed quantitative comparisons.

How users will analyse ECL disclosures remains to be seen. As comparing IFRS 9 methodologies is so complex, benchmarking the outputs becomes more important. New key ratios will likely emerge as additional analysis becomes available on how the ECL impairment model behaves.



The ECL provisioning model is a major change in how banks approach credit risk allowances. Beyond the impact of IFRS 9 transition, we expect stakeholder scrutiny on whether the new model better prepares banks to face economic downturns and promotes sound lending behaviour. The interaction between impairment allowances and the bank's risk appetite and pricing practices will continue to be key areas of focus for investors, standard setters and regulators.

In the short run, financial statement users will evaluate whether the ECL model and disclosures meet IASB's objective of providing relevant, understandable and comparable information about the amount, timing and uncertainty of future cash flows. This analysis highlights a number of areas that could benefit from enhanced

disclosures, with the most noteworthy being the definition of credit-impaired assets, write-off policies, and the sensitivity of ECL allowances to management judgement and estimates. We expect banks will continue to enhance the transparency of ECL disclosures in these areas and educate internal and external stakeholders on the drivers of changes in ECL in the near future.

We hope you find this information helpful as you continue your IFRS 9 implementation journey.

For questions and further information on how we can assist, please refer to [www.ey.com/gl/en/industries/financial-services/fso-capabilities-assurance](http://www.ey.com/gl/en/industries/financial-services/fso-capabilities-assurance).

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## How EY can help

Our Financial Services (FS) are an integrated area that includes many professionals and IFRS 9 experts across many countries (UK, Germany, France, India and many more), and collaborates across competencies (Advisory, Assurance, Tax, Transaction Advisory):

- ▶ EY has been engaged by many global banks for accounting change projects on a group-wide basis. We thus understand the complexities, challenges and opportunities of implementing IFRS across multiple geographies, business units and diverse portfolios.
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- ▶ We have gathered extensive IFRS 9 project experience and knowledge regarding key accounting and project decisions to be taken to allow quick and robust IFRS 9 implementation.
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