EY insights on expected credit losses in Q1 2020 and the challenges ahead

June 2020

Building a better working world

Contents

1. Introduction

In Spring 2020, EY performed a review of first quarter (Q1) financial disclosures made available by 18 banking institutions headquartered in Europe.

The purpose of this analysis was to understand how banks have managed the unique situation of the COVID-19 pandemic and the sudden global lockdown measures in their expected credit loss (ECL) estimates, considering a limited financial close timeline. Our focus was:

- The magnitude of the impact in Q1
- How the impact has been assessed
- The underlying ECL drivers
- How approaches on staging, scenarios, models and overlays could be compared

It is important to note that most Q1 communications are not International Financial Reporting Standard (IFRS) financial statements. Therefore, our analysis also considers other publicly available information, such as management or earnings reports and analyst presentations. A noted limitation of this approach is the significant diversity in terms of content, format and granularity, meaning comparisons between banks were challenging. Where this has led to assumptions, we have referred to this.

This document also considers how banks may prepare for the second quarter (Q2) 2020. Overall, the wider effect of new money poured on the market by governments, in particular state-guaranteed loans, was not yet visible as of the end of March, the Q1 end for all banks surveyed. We expect to see more of this effect in the half-year accounts.

The analysis was subsequently presented on an EY IFRS webcast for clients on 19 May 2020, "IFRS observations on Q1 impacts and attention points for half-year reports". During this webcast a number of polling questions were raised. Within this document the results for questions are captured within callouts.

A replay of the webcast is available below.

Find out more

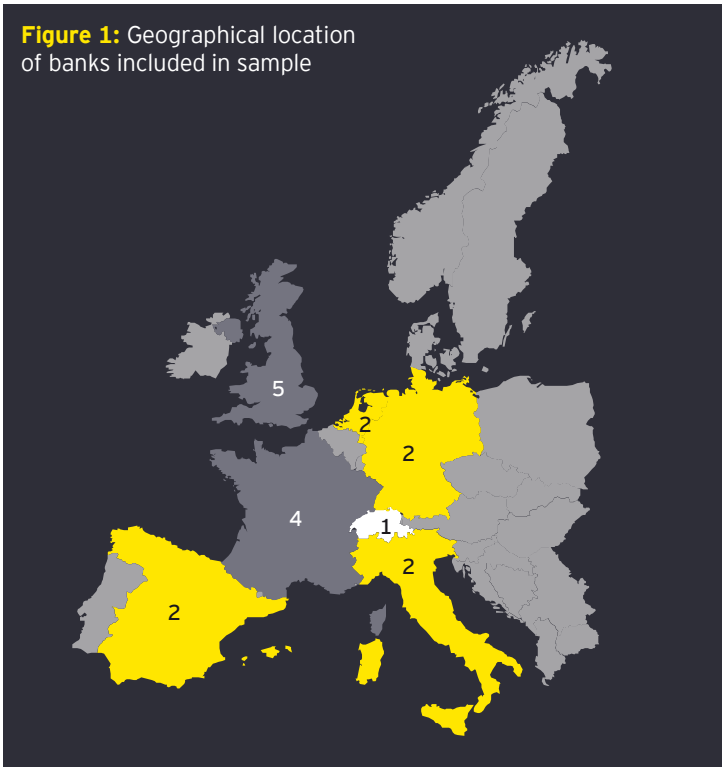
2. Analysis of the IFRS 9 impact at Q1: the sample population

The analysis was performed on banking institutions in France, Germany, Italy, the Netherlands, Spain, Switzerland and the United Kingdom. These banks are either classified as a Global Systemically Important Institution (G-SII) if head-quartered in the European Union, or else classified as a Global Systemically Important Bank (G-SIB) if headquartered elsewhere. However, it is important to bear in mind that there are significant differences in total balance sheet size for the sample population. This is a key consideration for both profit and loss impact and size of impairment allowances.

For the sample, the average size of "Gross loans to customers at amortised cost" is €512b, with four banks having in excess of €800b and four banks having below €300b[1]. The EY analysis within this publication focuses on these exposures as the primary scope. Figure 1 shows the geographical location of banks included in the sample.

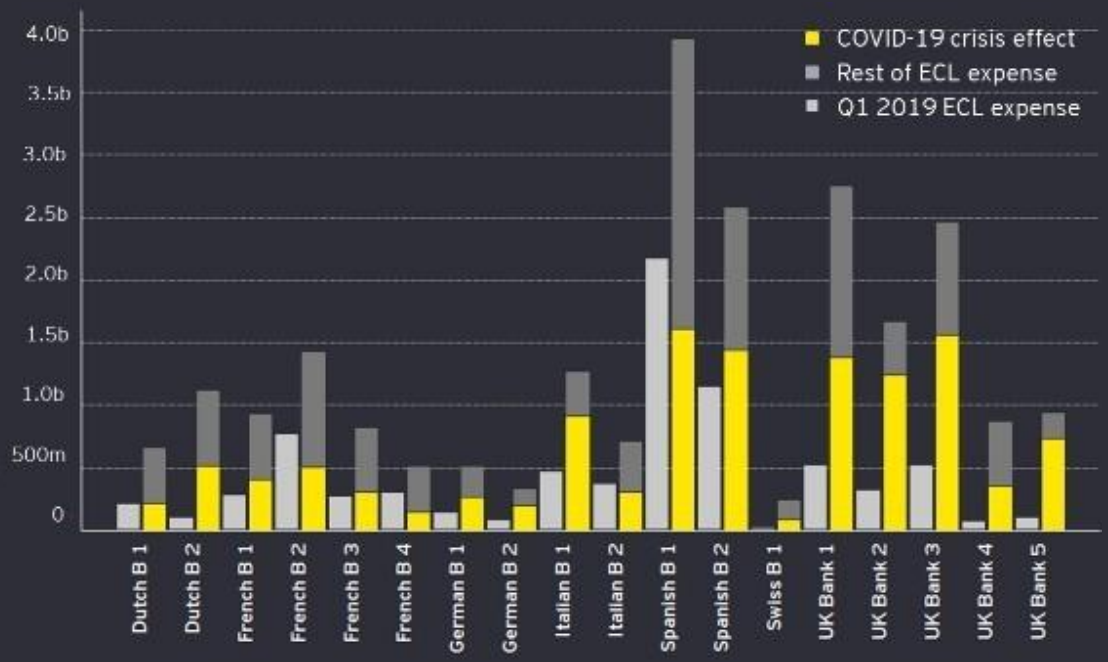
[1] *All currency conversions to Euro performed as at the exchange rate on 31 March 2020.*

Figure 1: Geographical location of banks included in sample



3. Expected credit loss (ECL) expense recorded for Q1'20

Figure 2: ECL expense for Q1'20 (€b)



3.1 The overall ECL expense

As shown in Figure 2, for the Q1'20 ECL expense incurred by banks, on average the charge was €1.3b, with four banks near or above €2.5b and the highest charge was €3.9b.

When compared with the Q1'19 expense, this represents an average multiple of five. For four banks, it is a multiple in excess of ten, however this is magnified by an extremely low charge for the comparative year at less than €100m.

3.2 The impact of COVID-19

All banks identified the magnitude of the COVID-19 effect in their communications, which reveals that the effect was assessed using "top-up" approaches compared with the "business-as-usual" process.

The isolated COVID-19 impact was on average a charge of €700m, which represents half of the average Q1 ECL expense. However, there was significant dispersion, with the COVID-19 proportion ranging from 10% to 80% of the total ECL expense. In the sample, three banks isolated 70% of their charge as due to COVID, an impact of c.€1b.

For some banks, the overall effect of COVID was subdued because of significant losses reported on single-name defaults, attributed to large clients in the Americas and in Asia. These losses tended to be categorized as stage three.

In general, stage three comprises on average 60% of the Q1'20 ECL expense for those banks that disclose the information.

A caveat to note is that less than half of the sample disclosed this staging allocation for the quarter loan loss expenses.

3.3 The use of management overlays

All banks in the sample referred to applying an ECL overlay, with significant diversity in approach. Disclosures tended to be limited, restricting comparison, however the following themes were observed:

Macroeconomic scenarios were a challenge for Q1: some banks revised them up until the last moment, some applied them directly into the models while others used them to run sensitivity analysis. Some banks reduced the number of scenarios, some even used their downside scenario only and others used flat rate adjustments.

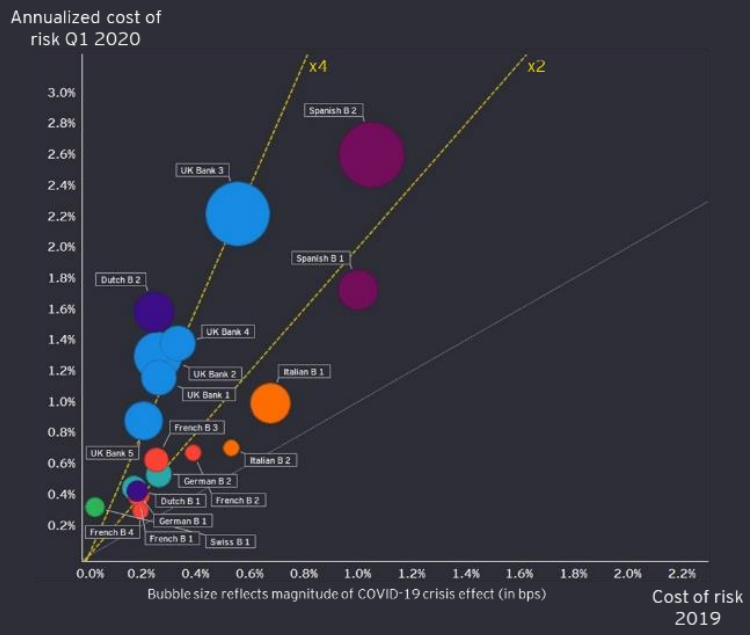
Portfolio and sectorial approaches were also a significant component of overlays: some banks stressed rating migrations, others transferred all or some portions of specific portfolios in stage two.

Management judgement was a major factor: this was consistently observed.

3. Expected credit loss (ECL) expense recorded for Q1'20 (cont.)

3.4 ECL expense recorded for Q1 2020: the cost of risk ratio

Figure 3: Cost of Risk (CoR) comparison between 2019 and Q1'20



A helpful way to consider the COVID-19 effect is through the lens of the cost of risk (CoR) ratio; that is the ratio between the annualised ECL expense and the gross loans balance.

While most of our sample disclose this indicator, the individual bank's methodology can differ. Therefore, it has been recalculated to ensure consistency, with the calculation including COVID-19 overlays.

Referring to Figure 3, the axis on the bottom shows the CoR for the full financial year 2019. Overall, banks were more concentrated in 2019 around an average of 38 basis points (bps), with higher values observed for Spain and Italy.

The vertical axis represents Q1'20 (annualised). As a visual aid, if the CoR had remained stable in Q1'20 all banks would sit on the diagonal; this cannot be observed for any banks in the sample.

The "bubbles" represent the magnitude of the COVID ECL expense with colours representing countries. The bigger the COVID effect in bps, the bigger the "bubble". The largest impacts are observable in Spain (with an average of 107 bps) and in the UK (with an average of 85 bps). Germany and France tend to show lower effects, at around 20 bps. For the other countries, the picture is contrasted with a wider dispersion around the mean CoR for individual banks.

When it comes to the slope of the increase between 2019 and 2020, the more significant the COVID-19 effect, the sharper the increase. Typically, UK banks are centred around a multiple of four, while Germany and France are closer to a multiple of two. However, there are a few nuances to observe: the slope is more moderate for the banks with a high CoR in 2019. This is generally the case for Spain and Italy.

Stage three losses again also drive the steepness of the slope, especially for those banks with significant single-name losses.

3.5 What do the trends show?

It is not easy to explain these trends, although several drivers can be noted:

- Significant overlays, with limited information provided:
  - In general, the overlay application is a "top up" process, which is usually not allocated into the different components of the IFRS 9 estimate (e.g. Stage two transfers, exposure at default (EAD), probability of default (PD) or loss given default (LGD) adjustments).
  - One bank discloses it as a "flat rate adjustment" and a number of banks disclose it as a total sum, whereby a large amount is isolated and disclosed in the communication, but no further detail is provided.

3. Expected credit loss (ECL) expense recorded for Q1'20 (cont)

- The geographical footprint:
  - Some banks reviewed have a broader international presence and may show significant impacts in countries where others do not have exposures.
  - Equally, some banks are subject to a number of smaller regional exposures that are significant once accumulated.
- The business profile, product mix and origination:
  - Divergence can be seen for wholesale exposures versus retail.
  - Equally, the weight of more fragile exposures such as credit cards or other unsecured loans. This is further discussed in section six.
  - In some countries such as the UK, the product mix and origination practices tend to react more to deteriorating macroeconomic parameters such as growth and unemployment. In the context of complete economic shutdown, this effect is magnified, and models tend to react more drastically.
- The expected effect of government support measures:
  - Some banks clearly express that this was considered as a significant mitigating factor, echoing the guidance from regulators. Banks expect the government measures will smooth the effects of the lockdown.
  - This is especially true in countries where banks consider that their origination policy results in more resilient portfolios.
  - There were various methods to measure it: smooth the macroeconomic scenarios to avoid overreaction from models, use negative overlays, or apply management judgment based on sensitivity analysis using revised COVID-19 scenarios. For each avenue, considerable judgement is required.
  - The macroeconomic scenarios and their weights:
    - In addition to forecasts, there were different approaches taken to weights. Some banks have weighted their downside scenario by 100%, while others have left the weights unchanged, considering that the revised baseline was now a lot more negative. Many banks have kept their downside scenario as is, while others have developed ad-hoc downside scenarios in addition to existing scenarios. However, weights are rarely disclosed in Q1'20 publications.
    - This is further analysed in section seven.
- Staging approaches:
  - It was often unclear if and how much the overlays were linked to stage two transfers. Banks have taken various approaches but as of Q1'20, specific indicators were generally not triggered and stage two transfers were the result of portfolio approaches.
  - This is further analysed in section four.

3.6 What is the outlook for 2020?

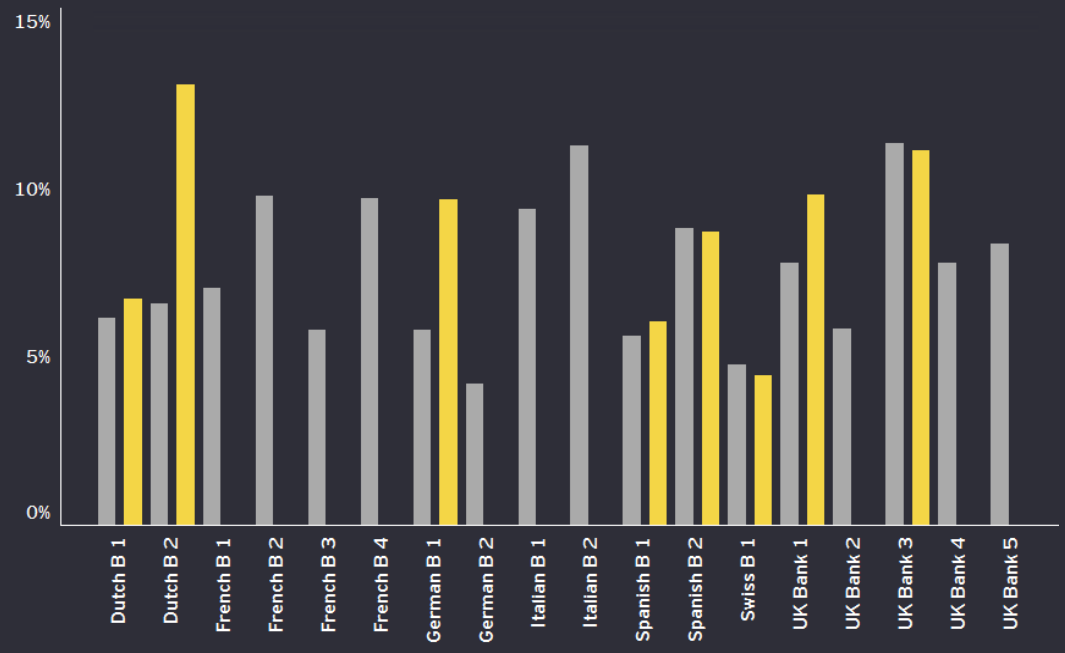
One key question is how much banks have frontloaded the expected losses or whether this will impact the outlook for 2020. Not all banks have provided an outlook but when they have, it was generally in line with the Q1 CoR (with the exception of banks that incurred significant single-name default losses). This means adding a similar impact every quarter or more.

This is partly due to stage two transfers as IFRS 9 is a gradual model (contrary to the US model), compounded by the guidance from regulators recommending that banks should not precipitate charges, in particular around moratoria, in light of massive government support measures. Additionally, some losses are expected on new loans and there is an expected further deterioration in economic outlook.

During the EY webcast, "IFRS observations on Q1 impacts and attention points for half-year reports", participants were asked for their banks projected full-year ECL expense level for 2020 as a multiple of the Q1'20 expense. Amongst those that were able to provide a response (55%), half expect the full year CoR to be above an annualised Q1'20 amount, while a quarter expect it to be at the same level as an annualized Q1'20 amount.

4. Stage two loan proportion growth

Figure 6: Percentage stage two ECL (compared to full book



4.1 Understanding the disclosures

Stage two is a key driver in the IFRS 9 model as it triggers a lifetime expected loss measure. Therefore, determining the impact of COVID-19 on stage transfers provides useful information.

As at Q4'19, banks reported a range of loans in stage two, with the proportion representing between 5% to 11% of the total loan book. Whilst only eight banks reported the stage two proportion in Q1'20, the effect of the COVID-19 crisis has often not translated into actual stage two transfers as at the reporting date. There are several explanations provided for this:

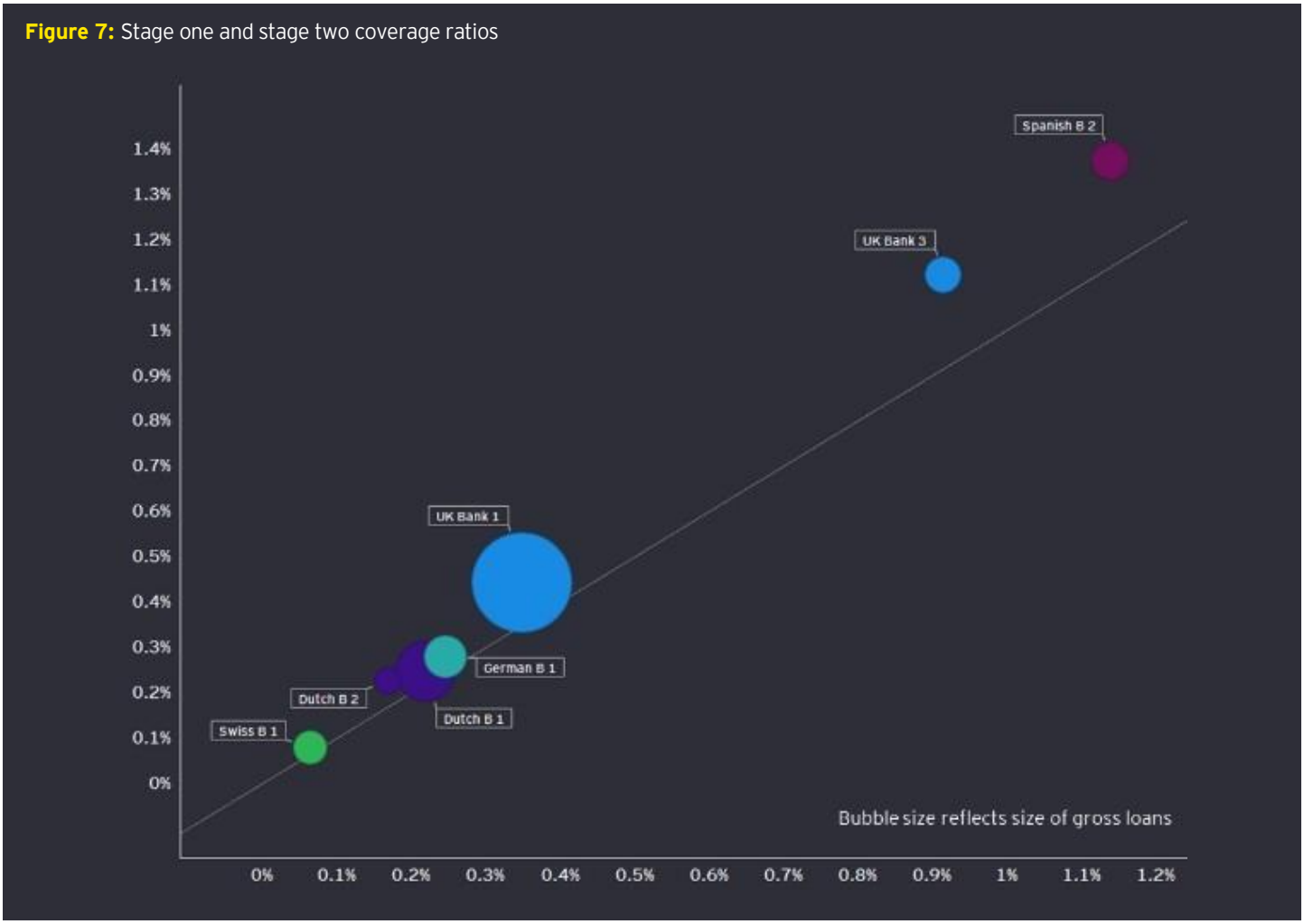
As per regulators' published guidance, payment holidays and moratoria have frozen arrears and have not triggered stage two transfers as they were generally not considered as forbearance measures.

Overlays have often not been cascaded into stage allocation.

There are a few exceptions due to a more radical approach and this is directly reflected in the magnitude of the COVID effect in Q1'20 (see "bubble" size in Figure 3). Where stage two transfers can be seen, this is cited as related to wholesale exposures and due to rating migration and / or a portfolio approach.

4. Stage two loan proportion growth (cont.)

Figure 7: Stage one and stage two coverage ratios



4.2 Analysis of stage one and two coverage ratios

Calculating the coverage ratio between the stage one and stage two ECL provision stock and the stage one and stage two loan stock can provide an indicator of the overall ECL approach taken by banks on their "good book" as well as an indication of the book quality.

The combined stage one and stage two coverage ratio is shown in Figure 7, with the ratio for Q1'19 shown on the x-axis and the ratio for Q1'20 shown on the y-axis. If both periods were aligned, the bank "bubble" position would be on the diagonal line.

Overall, all banks show an increase. Additionally, there is a correlation with the magnitude of the CoR COVID-19 effect in Figure 3. The book coverage dispersion remains wide – even in the economically "normal" period of Q1'19, the range was 0.06% to 1.14%.

A caveat to note is that by including stage one, the overall coverage reduces as new loans attract only 12-month ECL. This effect is notable for banks with a more pronounced increase in new loans or drawdowns of credit facilities.

As with other disclosures, limited banks provide this information. Therefore, determining country trends is difficult. Further disclosures are expected at half-year.

4.3 What is the outlook for 2020?

For future quarters, a number of banks outline their expectations. Banks expect more stage two transfers due to rating migrations, a higher default rate once payment holidays end, more backstops to be triggered and increased defaults in vulnerable sectors.

During the EY webcast, "IFRS observations on Q1 impacts and attention points for half-year reports", participants were asked if they expected significantly more stage two transfers in Q2 compared with Q1. A significant number of respondents (46%) expect this trend to continue, while a sizeable minority (26%) do not have a view, demonstrating the ambiguity in the market currently.

5. Gross loans and ECL balance sheet allowance at Q1'20

Figure 4: Gross loans to customers (€b)

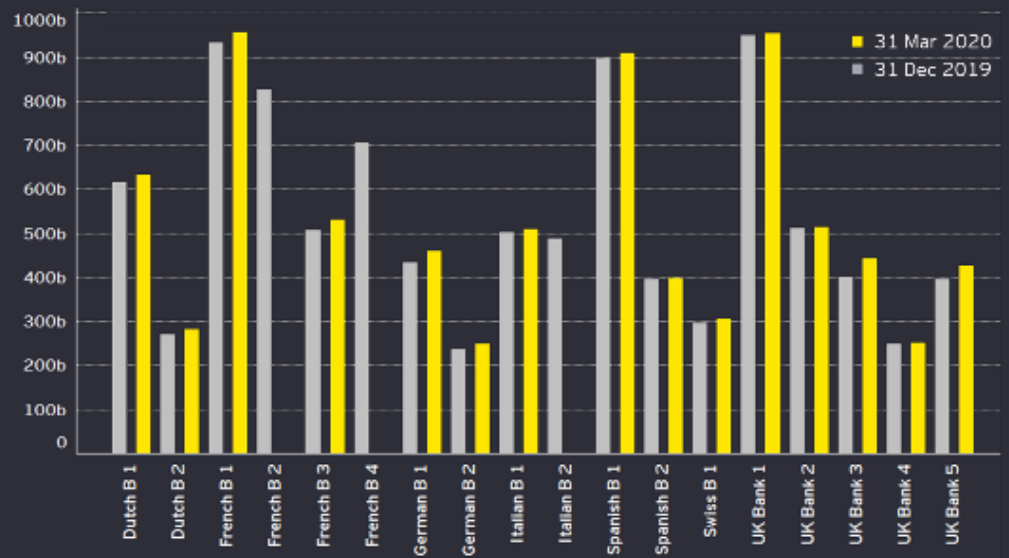
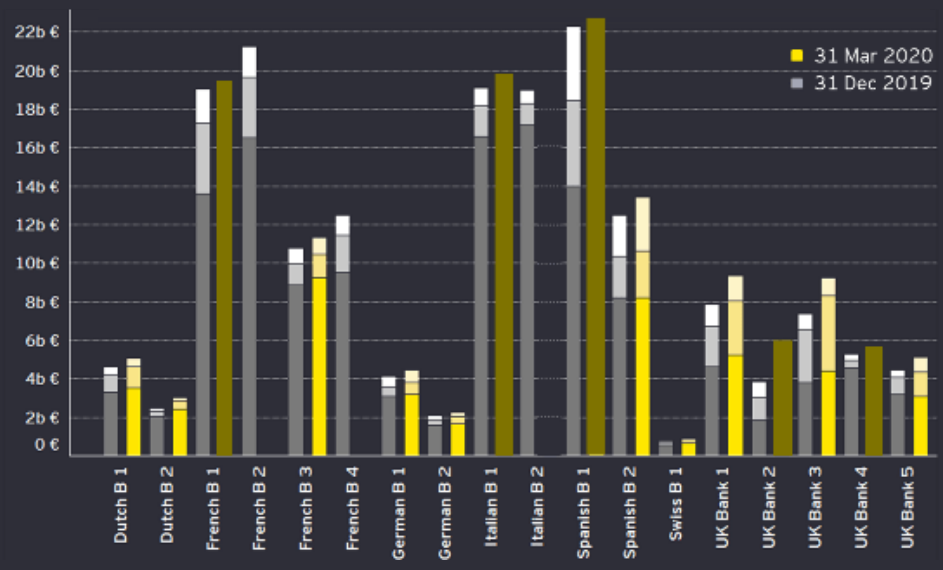


Figure 5: ECL comparison between Q1'19 and Q1'20 (including stage split where possible) (€b)



5.1 Exposure and ECL balance sheet analysis growth

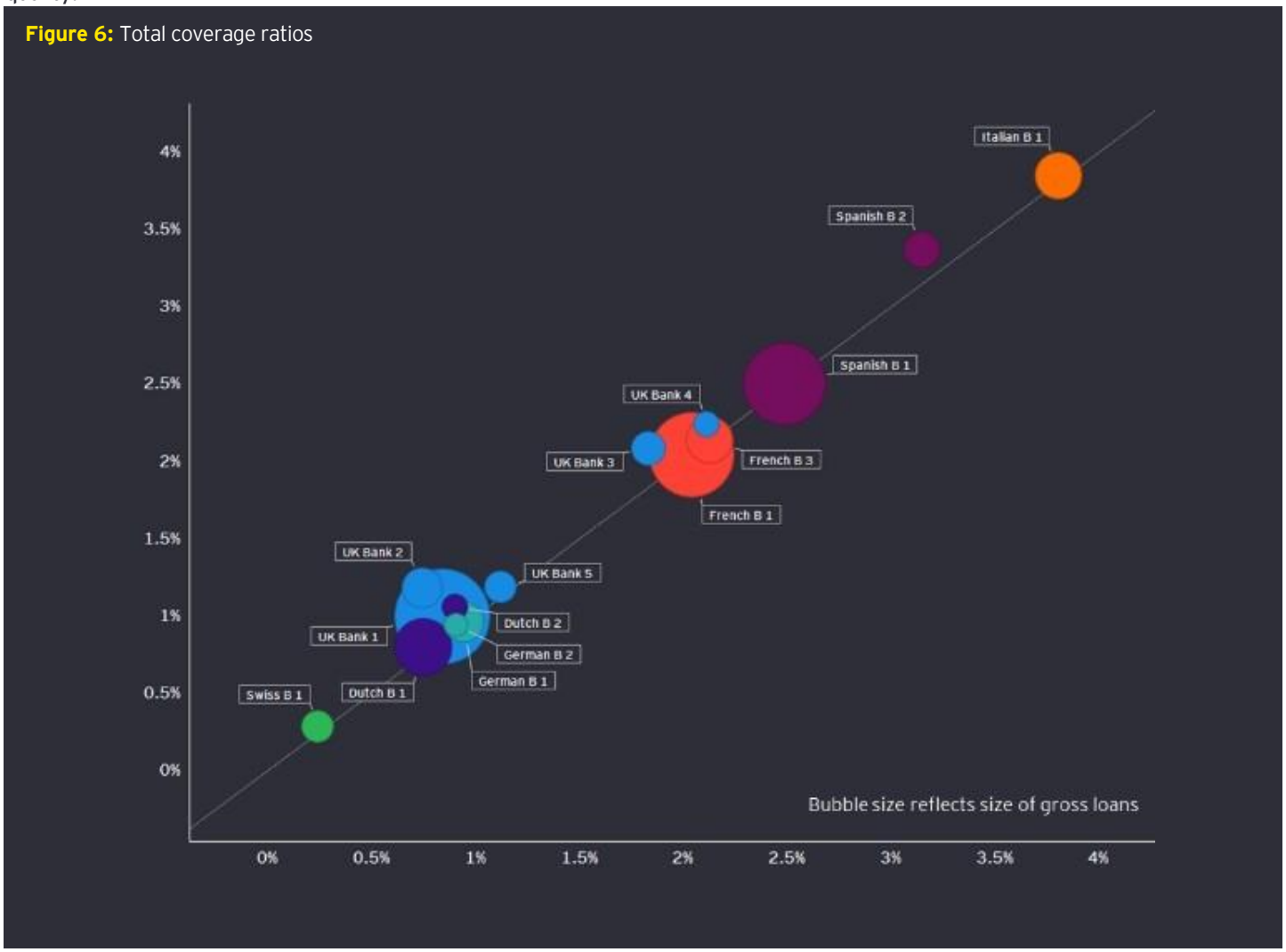
As shown in Figure 4, overall exposures have slightly increased by an average of 3%, with the highest being around 10%. This contrasts with Figure 5, which demonstrates that on average the ECL stock increased by 12%. For banks where data is available, the average allowance is now €9.2b and volume remains driven by stage three exposure. Although there are limited qualitative disclosures to analyse this further as of the end of Q1, the allocation of ECL by stage shows an increase in stage two ECL.

5. Gross loans and ECL balance sheet allowance at Q1'20 (cont.)

5.2 Analysis of total coverage ratios

Calculating the coverage ratio between the ECL provision stock and the overall loan stock can provide an indicator of the book quality.

Figure 6: Total coverage ratios



The total coverage ratio is shown in Figure 6, with the ratio for year-end 2019 shown on the x-axis and the ratio for Q1'20 shown on the y-axis. If both periods were aligned, the bank "bubble" position would be on the diagonal line.

The total coverage ratios remain relatively stable, although there is a wide dispersal ranging from 0.3% to 3.8%. Differences are primarily driven by stage three, as this category attracts the most significant ECL (with coverage ratios in stage three around 45% on average with some banks reporting 65% coverage). This reflects both the quality of the loan books as well as diverse write-off policies, with some banks writing off earlier (and showing lower coverage ratios). On average, the ratio is 1.7% and the average change is an increase of 0.1%. Unlike section four, a clear country-trend can be seen, as more banks disclose the underlying data.

6. Observable trends: the product and counterparty lens

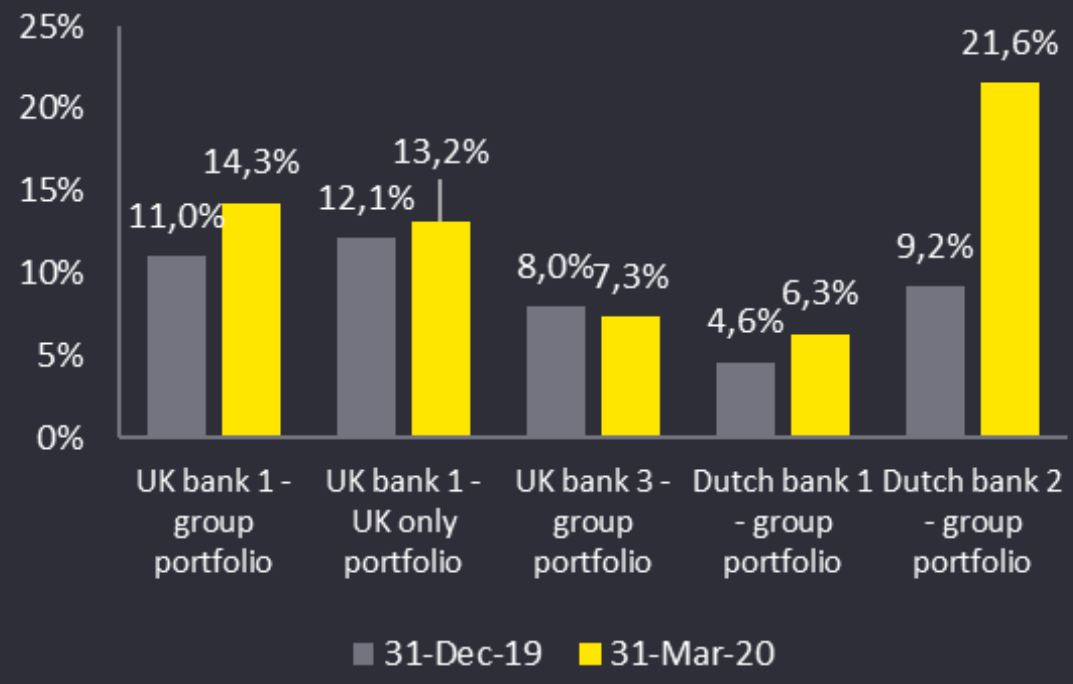
6.1 Wholesale and retail unsecured portfolios

Only a small sample or banks provide the ECL impact split between products. This means that determining whether the drivers are wholesale exposures, smaller businesses, retail unsecured or mortgages is not possible for most reporters.

For banks that do provide information, the most significant impact can be seen for the retail unsecured sector, where the charge is driven by revised scenarios and overlays. While this category shows the largest stage two increase, a number of banks state that triggers (generally based on payment behaviour, arrears and forbearance) have yet to be observed. This is followed by a pronounced impact for wholesale exposures, because of more negative rating migrations and portfolio overlays (linked to section seven, underlining the sector vulnerability analysis).

The approach to IFRS 9 staging is also diverse across banks, including between banks in the same country, as shown in Figure 10.

Figure 10: Stage two proportion of wholesale portfolio



The focus on this area is expected to grow in further quarters, given the anticipated future ECL charges. One bank highlights that the increase in ECL was driven by the higher probability of defaults from credit card lending and unsecured loans but that the impacts from the macroeconomic downturn caused by the COVID-19 pandemic are yet to be realised as at the quarter-end date.

6.2 Corporate exposures: vulnerable sector analysis

Analysis was performed on how banks communicated and dealt with heightened risk for certain sectors seen as most vulnerable to COVID-19. This approach was a key driver of the observed impacts.

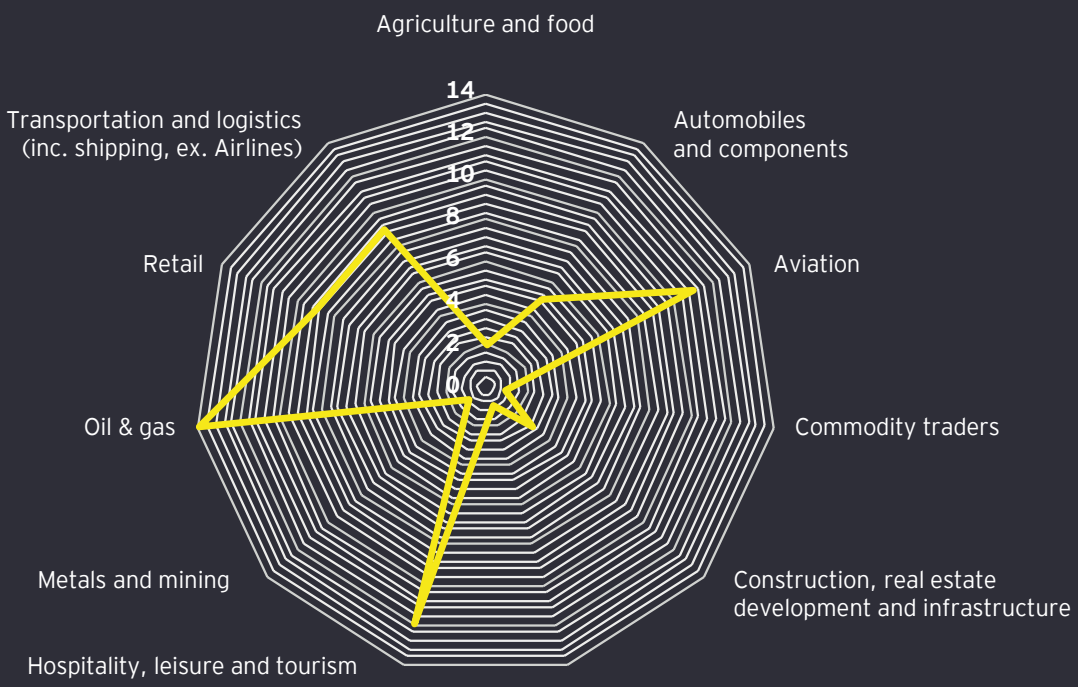
For these sectors, the impact could be expected to be harder and quicker because of less mitigation from support measures, more rapid rating migration and the effect of concentration.

6. Observable trends: the product and counterparty lens (cont.)

Most banks disclose corporate exposures to identified vulnerable, high risk or named sectors and specified the sector vulnerability is magnified by COVID-19.

The most frequently cited sectors are: oil and gas; hospitality; leisure and tourism; aviation; retail; and transportation and logistics (including shipping), as shown in Figure 9.

Figure 9: Number of banks citing exposures



The information provided is not homogeneous and covers different types of information: maturity; drawdowns; collateral quality; percentage classified in high risk category; and oil and gas sensitivity. For this final point, several banks separate the oil and gas sector from COVID-19 as the situation had already deteriorated prior to the COVID-19 crisis.

There were some more or less radical approaches to stage transfers. But transparency is this area is limited:

- Although some banks provide the internal credit gradings for vulnerable sectors, most banks do not disclose how the internal credit gradings map to the IFRS 9 staging allocations.
- The credit assessment categorisation diverges between banks. A UK Bank has categorised 20% of its aviation exposure as on an internal watch list; whereas another one has categorised the full aviation exposure as on an internal watch list.
- A number of banks referred to sectors limited credit rating migrations in Q1, with expectation of negative rating migrations to occur in the remainder of 2020. Some banks mentioned that ECLs may be adversely impacted by increased levels of default for single name exposures in certain sectors directly impacted by the COVID-19 pandemic (such as the oil and gas, retail, airline, and hospitality and leisure sectors).
- One bank refers to significant upfront collective provisioning for sectors immediately impacted by COVID-19 and oil prices. Significant stage two transfers in these sectors is also noted.

7. Macroeconomic forecasts

7.1 Forecasts for 2020

Figure 11: Q1 reporting scenarios: UK gross domestic product (GDP) growth 2020 (projected)

Figure 12: Q1 reporting scenarios: Euro-zone (EZ) GDP growth 2020 (projected)

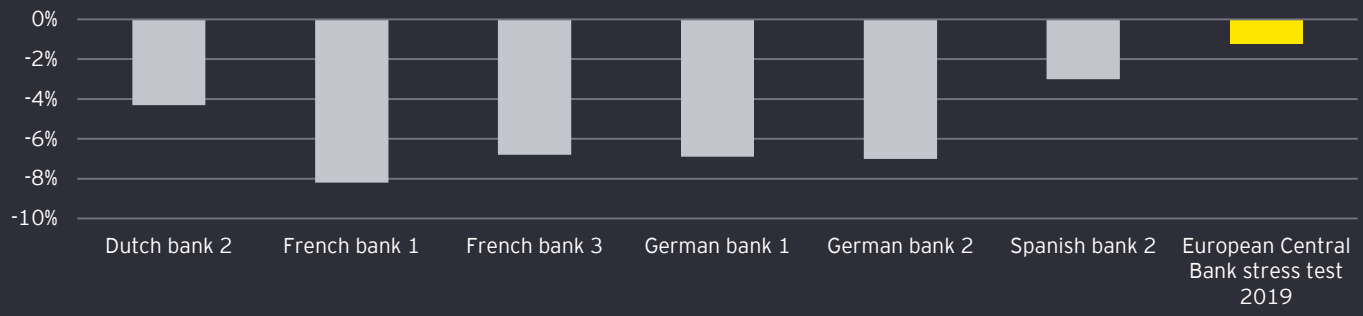
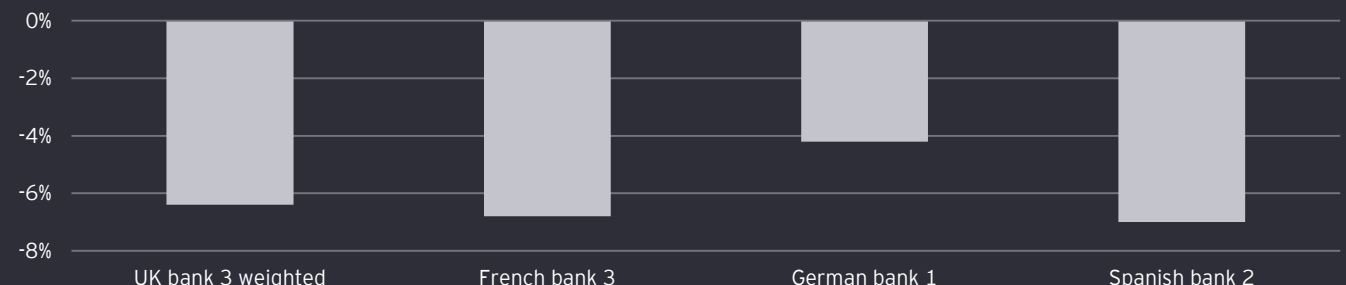


Figure 13: **Q1** reporting scenarios: US GDP growth 2020 (projected)



A focal point is the consistency across banks for the forecasts used in their estimates in Q1.

Overall, the more pessimistic scenarios are not reflective of the biggest COVID-19 impacts observed.

Figure 11 and Figure 12 show a comparison to the 2019 regulator stress scenarios. It is clear that the scale of shock seen is significantly in excess of previously envisaged GDP falls as shown by the 2019 Bank of England and European Central Bank (ECB) stressed scenarios. As such, banks faced a challenge to update their existing forecasts. This was difficult in Q1'20 as actual data was limited. As a result, both UK and EU forecasts used in Q1'20 were less severe than consensus outturns as at end of Q1 available after the end of the closing process. As such, further adjustments can be expected through the next quarter as actual data becomes available.

The US forecasts used by European banks were more in line with consensus.

7. Macroeconomic forecasts (cont.)

7.2 Forecasts for 2021 and beyond

Figure 14: Q1 reporting scenarios: UK gross domestic product (GDP) growth 2020 (projected)

Figure 15: Q1 reporting scenarios: EZ GDP 2020 and 2021

Looking beyond the 2020 outlook in Figure 14 and Figure 15, the challenges of forecasting increase and this is reflected in both the scenarios used and also in the significant difference between the stressed scenarios developed by the Bank of England and the ECB. Moving forward, more consideration would be expected on how COVID-19 has spread and the evolving government support, as well as the economic responses of businesses and consumers to the easing of restrictions.

During the EY webcast, "IFRS observations on Q1 impacts and attention points for half-year reports", participants were asked when they expect GDP to return to 2019 year-end levels. Responses to the polling question suggest that the current expectations of recovery are consistent with a less favourable outlook than was used in Q1'20, as nearly 60% of respondents believe GDP will return to 2019 year-end levels only by 2022 at the earliest. However, as 20% of respondents were unable to respond this highlights the level of uncertainty for projections.

7.3 Considerations in assessing macroeconomic scenarios and assumptions moving forward

In Q2 and beyond, more data on what has happened will be available and this will need to be incorporated into forecasts. The wide range of likely impacts across sectors and individual businesses does mean that overlays will be required to capture impacts that top-down models (based on national economic data) may be unable to reflect. The question of when the economy will revert to its long-term growth rates and what that growth rate will be, was not really considered in Q1'20 but will be an important topic for reporting in Q2'20 and beyond.

Key considerations underpinning macroeconomic estimates will include the following:

- Incorporation of Q'20 actual data into base case and scenarios/simulations
- Consideration of:
  - Possible medical developments/risk of second wave
  - Back-to-work guidelines
  - Government support programmes
  - Consumer and corporate responses
- Time profile: year-end, return to trend, level of trend given potential structural shifts
- Scenario weights and confidence in base case
- Sector-specific analysis and reconciliation to scenario envelope
- Comparison to regulator "scenarios"
- Process used to develop final view

8. A view from US banks

As of Q1'20, the US generally accepted accounting principles (GAAP) required the current expected credit loss (CECL) methodology to be applied by most US banks. These banks reported significant increases in their allowance for credit losses as at Q1'20. In addition to the adoption of CECL, which generally resulted in an increase in the allowance for loan losses, significant additional credit losses were recorded as a result of the expected impact of the COVID-19 crisis. Given the unique nature of the crisis, many organisations used overlays to estimate expected credit losses.

8.1 A reminder on the adoption of CECL

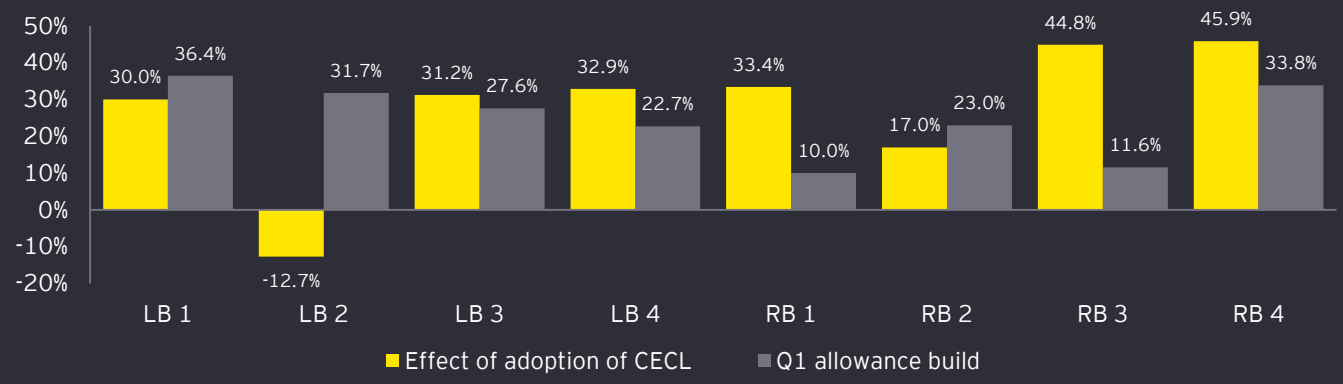
In order to reflect upon this data, a number of observations about the adoption of CECL should be highlighted first.

Most US banks were required to adopt CECL at the beginning of 2020. While the impact of adoption varied significantly, a number of themes were observed on Day-one:

- Allowances for retail products, such as mortgages, increased as banks attempted to reflect a lifetime loss estimate. The most significantly impacted product was credit cards.
- Allowances for commercial or wholesale loans either were unchanged and in some cases decreased. While a decrease may seem counterintuitive, many of these loans have relatively short lives, and the estimate of losses under CECL is limited to the contractual life of the relationship (i.e., extensions and renewals are not included within the calculation).
- There was significant effort and cost incurred in building the models for CECL with many of the larger banks leveraging elements of their stress-testing models.
- Finally, the adjustments to reflect the adoption of CECL were made as of 1 January and therefore did not include the impact of COVID-19.

8.2 Observations on the impact of COVID-19 for US banks

Figure 16: US banks – allowance build



The allowance-build as at the date of adoption and as at Q1'20 is shown in Figure 16, demonstrating that Q1 results varied significantly across US banks. This sample comprises four of the largest US banks with the most diversified business models (denoted by LB) and four large, more traditional regional US banks (denoted as RB). Each of these banks are within the top 15 US banks in terms of asset size.

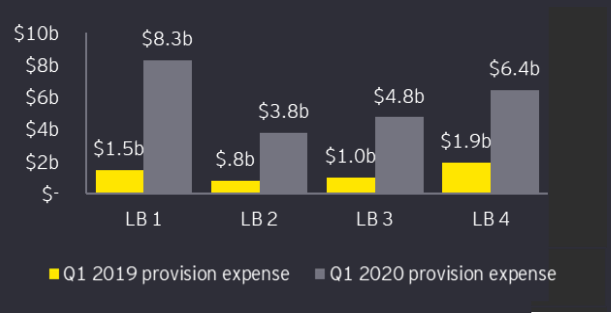
To analyse the supporting disclosures, two factors should be borne in mind. Firstly, Q1'20 was the first quarter that the US banks applied their expected loss methodology, CECL.

Secondly, while the transition to CECL does represent a move to an expected loss methodology (compared to an incurred loss basis), there remain significant methodology differences between CECL and IFRS 9.

Unlike IFRS banks, who generally had two years of ECL application as historical background, US banks had to make an estimate for Q1'20 provisions in light of the impact of CECL and the impact of COVID-19.

8. A view from US banks (cont.)

Figure 17: Large bank Q1 provision expense – 2019 versus. 2020



As can be seen in Figure 17, there was a wide range of results with several banks recording provisions that were four to five times higher than the same quarter last year

Generally, banks developed their estimate using existing models and methodologies, but overlays took an even more prominent role given the amount of estimation uncertainty.

Based on what was made publicly available, most of the banks used forecasts developed in mid to late March 2020. These forecasts showed worsening conditions relative to earlier in the quarter, including a high single-digit unemployment rate. However, several banks commented that as the financial close and reporting process was finalised, conditions continued to deteriorate as jobless claims began to spike in early and mid-April 2020. This worsening data may have influenced how banks set their qualitative adjustments. Several banks acknowledged that the forecasts worsened further, with further disclosures potentially foreshadowing additional losses in Q2'20.

8.3 Sectoral breakdowns

Looking more closely at the results, commercial portfolios were generally impacted more than consumer portfolios, with variation again at the product level.

The rise in commercial provisions was likely driven by:

- Low starting allowances as a result of CECL adoption during a benign credit environment.
- A reflection of industry-specific issues, including extremely low oil prices on the energy portfolios.

Clearly, exposure to hard-hit industries like energy, hospitality and the airlines drove relative performance.

For consumer lending, the key drivers were:

- Increases were generally driven by credit card portfolios:
  - Most of the impacted banks set coverage at 8-10% of total loans. Again, this is noted for IFRS banks in section eight.
- Other consumer portfolios, including mortgage, home equity and auto finance were less hard-hit, likely due to two factors:
  - First, unlike the previous financial crisis in 2008, it is expected that collateral values will not be as significantly impacted in the short term.
  - Second, the estimated benefits of fiscal stimulus and extensive loan modification programs that have been put in place. These impacts were extremely hard to estimate and likely represent a significant source of uncertainty in the estimate.

As with the IFRS results, high judgment is required placing a premium on clear and transparent disclosure.

8.4 Comparing IFRS and US GAAP expected loss impact

While both CECL and IFRS 9 are expected loss models, there are key methodology differences when comparing the results.

- CECL requires a lifetime loss to be reflected for all loans at origination or purchase, and there is no concept of staging. This could cause a meaningful difference particularly if losses are expected to manifest beyond twelve months.
- Discounting should be considered. Unless a loan is impaired, most US banks are using a non-discounted approach while discounting is required under IFRS 9.
- However, the requirement to use a probability weighted forecast under IFRS 9 is probably not as large a driver of difference, as many of the larger US banks also use or consider multiple economic scenarios.
- Furthermore, the view of national and supranational regulators may provide some steer on judgement, as several have provided guidance statements since the advent of the pandemic.

9. Accounting and reporting attention points for half-year

To prepare for half-year accounts, a review of Q1 communication is a useful starting point.

Additionally, the questions raised by analysts during the earnings presentations provide further insight into users' concerns, with a focus noted on the CoR (such as macro-economic assumptions, base scenario versus downside, the bank's outlook and guidance for credit risk losses), as well as dividends and capital ratio.

Also, banks will have more perspective on the economic consequences of the lockdown. They will also have had more time to adjust their processes and governance to face the new environment.

A number of regulatory and supervisory bodies have published statements or guidance. For example, the European Securities and Markets Authority (ESMA) has published a statement about the "Implications of the COVID-19 outbreak on the half-yearly financial reports."[2] Banks will be expected to consult these documents where appropriate.

Find out more

9.1 Macroeconomic scenarios and assumptions

The more we move forward into the crisis development stage, the more it will become the new reality. This ultimately means a replacement of old scenarios, rather than the current incremental approach, and less information on the COVID-19 isolated impact. Therefore, as uncertainty continues to prevail, the revised baseline scenario appears similar to the previous downturn scenario used in a stable economic environment. This will impact the multi scenario approaches, and there will be interaction with stress scenarios to consider.

Key to explain how this unfolds is consideration of "what is the new normal?" and areas for disclosures to consider include:

- How the COVID-19 crisis has been incorporated in the macroeconomic scenarios
- How new scenarios compare with the previous ones
- Weights and underlying rationale
- Sensitivity analysis and outlook for the full year
- How government relief measures have been reflected
- Overlays and how they are connected with the rest of the IFRS 9 ECL disclosures
- If and how the usual IFRS 9 ECL estimate process and governance of the bank have been adjusted for the purpose of the half-year accounts

9.2 COVID-19 crisis loans and government relief measures

- **There is significant variety in countries' schemes and it is key to explain them. It is also important to explain the accounting approach, depending on the complexity of the local schemes (in particular for state-guarantees and moratoria). Useful examples can be seen at Q1'20, in particular for the staging approach to payment holidays, other moratoria and the impact on arrears triggers.**
- **For some banks assessed, disclosures are provided which explain the measures and the amount of related exposures. The magnitude of payment holidays and when they are expected to end is key to understand future developments.**

Areas for disclosures to consider include:

- Main features of the schemes implemented by the bank: state-guaranteed loans, public / private moratoria (with or without waiver of interests)
- Related exposures
- Accounting analysis of the schemes:
  - Initial recognition of the loans
  - Effective interest rate calculation
  - Effect of guarantees
  - Modification accounting
- Risk monitoring approaches
- Expected effect of unwinding of public and private moratoria
  - Impact on arrears
  - Impact on stage two transfers

[2] "Public statements", ESMA website, https://www.esma.europa.eu/sites/default/files/library/esma32-63-972_public_statement_on_half-yearly_financial_reports_in_relation_to_covid-19.pdfyearly_financial_reports_in_relation_to_covid-19.pdf, 20 May 2020, accessed 28 May 2020".

9. Accounting and reporting attention points for half-year

9.3 ECL movements and outlook

Through movements and outlook, users can determine the story. Qualitative disclosures can explain how the different components of the estimate have played out for the quarter, e.g., individual risk indicators, treatment of moratoria, models, scenarios, overlays and what it means for the future.

Areas for disclosures to consider include:

- Categorisation of ECL impacts:
  - Stage three losses (including single names)
  - COVID-19 crisis scenarios
  - Portfolio approaches
  - Stage two movements
  - Overlays
- Vulnerable sectors: concentrations, portfolio approaches (staging or ECL), overlays
- Shape of expected default curve
  - Time-lag due to support measures
  - Impact on outstanding portfolios (maturity profile) and future origination
- Stage two transfers:
  - How much has already materialized and related triggers (e.g. delinquency or forbearance)
  - Exceptions to business as usual approach (differentiation between COVID moratoria and forbearance)
  - Portfolio approaches
- The objective here is to say how much has been captured, providing users with an understanding also of potential outlook.

10. How EY can support

Recognising that the effects of the current uncertain economic environment will continue to impact IFRS 9 ECLs, we believe banks should consider a comprehensive response to the challenges facing their operating models and proactively plan for the second half of 2020 and for 2021.

This could mean revising the IFRS 9 operating model and increasing the external disclosures – including the underlying IFRS 9 models, input data, processes and key policies – to reflect what may be the "new normal". These changes will place banks in a more secure position to generate supportable outcomes for decision-making purposes and rely less on expert judgement alone.

A more strategic approach will need to be designed and implemented to address some of the shortcomings of the current methodology and operational processes highlighted in the past quarter. This may require that banks maintain some of the existing tactical fixes in the immediate term, while in parallel designing a robust framework to align their IFRS 9 operating model strategically.

Linkages to the stress testing and financial planning and analysis process should be fully incorporated, both for the further scenario analysis and also in light of the use of management overlays.

Additionally, the approach to credit risk management must be considered. The themes highlighted in this publication demonstrate that the current assessment process should be strengthened to incorporate the financial ecosystem of counterparties. This will require a tactical change in the immediate-term considering methodologies, but the long-term approach can leverage emerging technologies to ensure full alignment to strategic objectives. This will strengthen the resilience of banks and assist in identifying profits in a restrictive economy.

At EY, we have developed a number of tools that can support this analysis. The graphs produced in this publication were created using "EY Spotlight". This is a powerful analytical tool that efficiently addresses the challenges of IFRS 9 modelling in these unprecedented times by providing deep insight about COVID-19 impacts on ECLs at a glance.

It can provide real-time updates on the status of COVID-19 globally, the macro-economic impact and forecasts of market participants, as well as regulatory updates, to create transparency about the development of the crisis. Based on this detailed information the tool allows a user to simulate the impact of COVID-19 on loan losses, taking into account deterioration of credit quality and relief measures. In addition, COVID-19 related ECL-results and assumptions can be benchmarked with market participants.

11. EY contacts

EY teams have deep experience of IFRS 9 implementation and understand the complexities around disclosures. We are able to advise and support on augmenting your current process, reflecting the guidance of regulators and the concerns of users.

Your local EY contact or the contacts listed below will be able to discuss your requirements in further detail.

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