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Financial Reporting Supervision

Information Note

APPLYING IFRS 9 *FINANCIAL INSTRUMENTS* – EXPECTED CREDIT LOSSES

IAASA
Irish Auditing & Accounting Supervisory Authority

Mission

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest.

About IAASA

The Financial Reporting Supervision Unit of the Irish Auditing and Accounting Supervisory Authority examines the compliance of certain entities' periodic financial reporting with relevant reporting frameworks.

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Key messages in this Information Note

- Users of banks' periodic financial reports should carefully review and analyse the totality of the expected credit loss information disclosed and, in particular, information about:
    - material post-model adjustments (management overlays)
    - judgements surrounding significant increase in credit risk
    - changes to forward looking information
    - changes in expected credit loss allowances and expected credit loss sensitivity disclosures
- Banks have improved the quality of their disclosures of financial assets and liabilities in recent years
- IAASA encourages all banks to strive for further improvements in the level of transparency for the topics identified in this information note. IAASA encourages banks to provide more entity-specific and granular quantitative and qualitative information to users of their reports
- IAASA expects that as COVID-19 pandemic relief measures and supports are withdrawn, the longer-term impact of the pandemic on banks' expected credit losses will become more apparent. Additional disclosures and greater transparency of these impacts on expected credit losses should be disclosed in banks' periodic financial reports

1. Background – expected credit losses

IFRS 9 *Financial Instruments* (IFRS 9) sets out an impairment model based on an expected credit loss model for financial instruments. IFRS 9 was developed by the International Accounting Standards Board and became effective in 2018.

Since its first application, IAASA has examined how banks have applied the key judgements in IFRS 9. This Information Note is based on observed trends in the application of IFRS 9 by banks, in particular since the start of the COVID-19 pandemic.

2. Purpose of this Information Note

The purpose of this Information Note is to:

(a) encourage users of banks' periodic financial reports to carefully review and analyse the totality of expected credit loss (ECL) information disclosed in banks' periodic financial reports and, in particular, topics highlighted in this Information Note, and

(b) assist preparers, management, directors and audit committee members when preparing and approving financial reports to highlight areas where high quality disclosures can be provided under IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures* regarding banks' presentation and disclosure of ECLs.

3. ESMA public statements

In its public statement[1] released in March 2020, the European Securities and Markets Authority (ESMA) addressed the implications of the COVID-19 pandemic on banks' application of IFRS 9.

ESMA's public statement European common enforcement priorities for 2020 annual financial reports statement[2] highlighted the importance of providing disclosures on:

- macroeconomic scenarios and post-model adjustments
- explanations of changes in ECL loss allowances by classes of financial instruments compared to prior periods
- details on risk concentrations, and
- the impact of support/relief measures on the assessment of significant increase in credit risk (SICR)

IAASA appreciates that all banks are applying IFRS 9 at a time when the depth and duration of COVID-19 restrictions and the trajectory of any recovery remain uncertain. IAASA expects that banks will take steps to improve the level of transparency in key areas of IFRS 9 in their periodic financial reports to assist users' understanding of these uncertainties.

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[1] https://www.esma.europa.eu/sites/default/files/library/esma32-63-951_statement_on_ifrs_9_implications_of_covid-19_related_support_measures.pdf
[2] https://www.esma.europa.eu/sites/default/files/library/esma32-63-1041_public_statement_on_the_european_common_enforcement_priorities_2020.pdf

IAASA believes that the matters raised in this information note may be relevant to a wider range of entities that apply IFRS 9 and which do not fall within IAASA's remit.

4. Expected credit loss trends 2019 – 2021

The banks referenced in this Information Note are listed on the main market of Euronext Dublin and are within the scope of the Transparency Directive.

- AIB Group plc (AIB)
- Bank of Ireland Group plc (BoI)
- Permanent TSB Group Holdings plc (PTSB)
- Bank of Cyprus Holdings plc (BoCH)

ECL allowance movements

The ECL allowance movements for the four banks from 30 June 2019 to 30 June 2021 are set out in Chart 1. This time span covers both the pre-COVID-19 period (HY 2019) and ECL movements since the start of the pandemic.

CHART 1

ECL AS PERCENTAGE OF GROSS LOAN BOOK

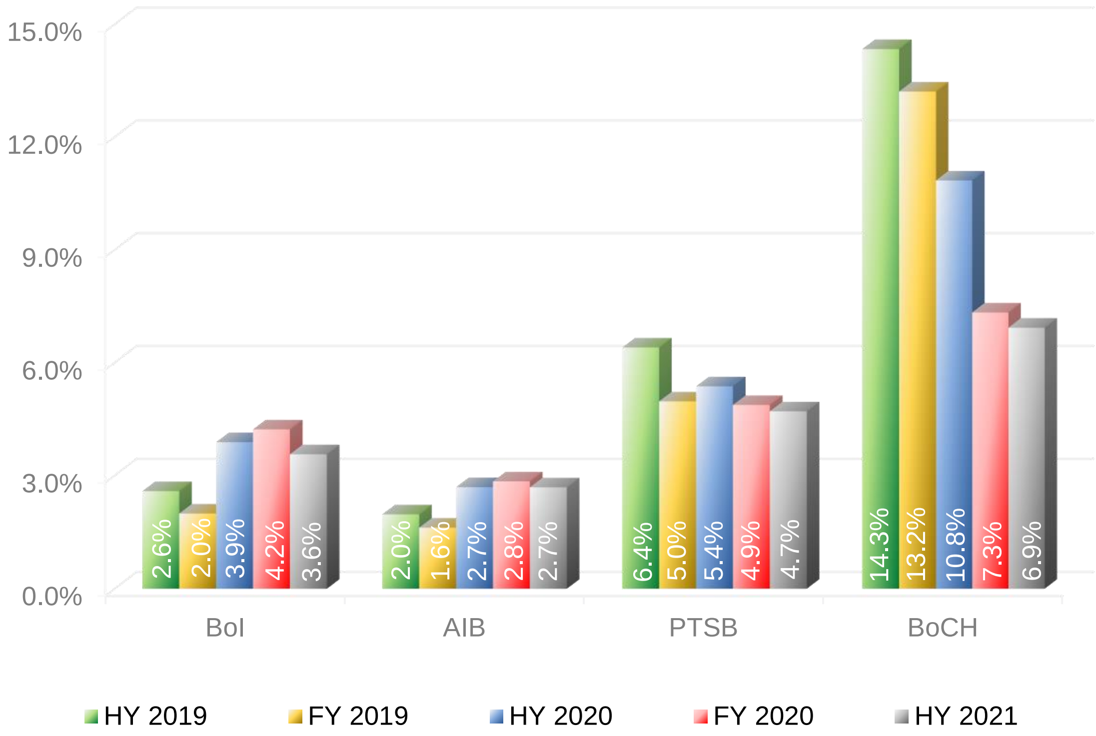

Chart 1 on the previous page shows that:

- Variances in the relative ECL allowance movements can be seen across the different banks
- BoI and AIB recognised a significant and rapid increase in the relative levels of net ECL allowance since the start of the pandemic. This is also reflected in the significant increase in the absolute level of ECL allowances recognised
- PTSB recognised a relatively lower percentage increase in the net ECL allowance at the start of the pandemic; however, the ECL coverage ratio is at a relatively higher level relative to gross loans, and
- BoCH reported a progressively large net reduction in the ECL allowance over the periods which appears to be due to a combination of entity-specific factors (such as asset write-offs, sales of non-performing loans and other deleveraging strategies).

It is necessary to consider the individual components of each bank's loan portfolio and the strategies applied to manage individual bank's ECLs over time in order to fully understand and contextualise:

- the ECL income statement impairment charges, and
- the ECL allowance and movements in ECLs.

ECL post model adjustments

Chart 2 on the next page shows that the amount of the ECL post-model adjustments[3] (also known as management overlays) are material relative to the corresponding ECL income statement impairment charge.

[3] ECL "post-model adjustments" or "management overlays" refer to adjustments to the ECL allowances generated by models. Typically, these adjustments are made where management consider that the ECL model output does not adequately capture all available information, such as (i) forward looking information (ii) a significant degree of uncertainty (iii) late breaking events for which there was insufficient time to incorporate into models or (iv) insufficient observable data available.

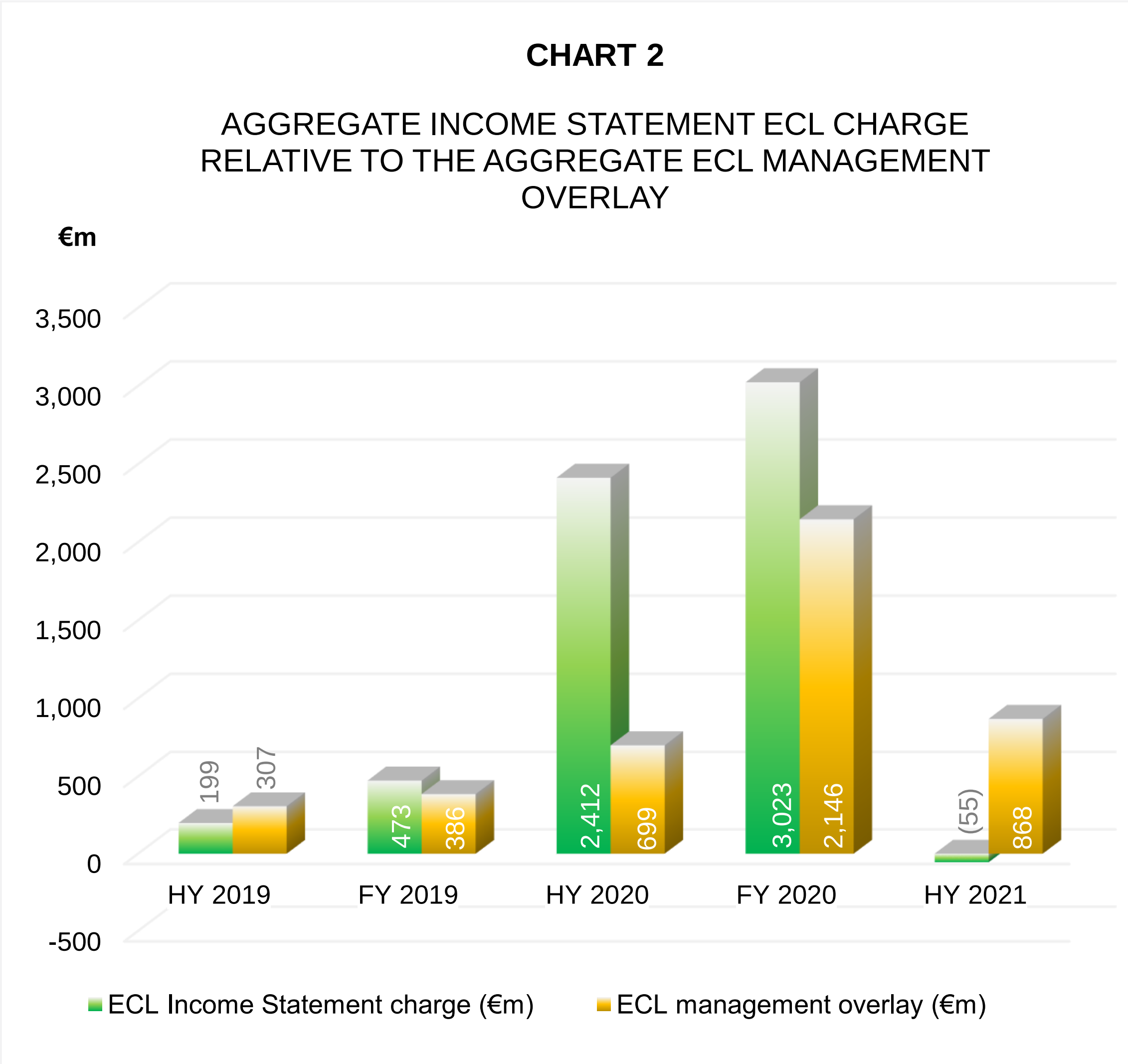

Chart 2 presents aggregated ECL data for the four banks. Points to note include:

- the rapid and significant increase in the ECL impairment charge in the income statement at the start of the pandemic relative to pre-COVID-19 ECL impairment charges (consistent with an expected loss model)
- significant reduction in ECL impairment charges (or writebacks) recognised in the income statements of banks during the HY 2021
- rapid increase in the level of ECL post-model adjustments recognised by the banks since the start of the COVID-19 pandemic, and
- material ECL post-model adjustments continue to be recognised by three of the four banks at 30 June 2021

The level of ECL post-model adjustments suggests that, at the reporting dates, banks had not yet fully embedded significant levels of uncertainty into their ECL models for reasons that are specific to each bank and its particular circumstances.

5. IAASA's observations on banks' ECLs

IAASA has noted some overall improvements in the quality of IFRS 9 and related IFRS 7 disclosures by banks in recent years. However, IAASA believes that there is scope for further improvement in the following areas:

- greater transparency in ECL qualitative and quantitative judgements and estimates
- more granular and entity-specific disclosures, and
- enhanced qualitative explanations and improvement in the transparency of disclosures surrounding:
  - the determination of SICR and changes therein
  - post-model ECL adjustments
  - incorporating forward looking information into impairment models and changes therein
  - explanations of changes in ECL loss allowances, and
  - ECL sensitivity disclosures.

IAASA calls on preparers to consider how the key IFRS 9 judgements in these areas can be disclosed with greater transparency for users of their financial statements.

IAASA encourages users of banks' periodic financial reports to diligently analyse the totality of ECL information disclosed in banks' periodic financial reports and particularly in the above areas. Users are encouraged to analyse differences between material sub-portfolios where it is necessary for an understanding of the banks' IFRS 9 judgements.

6. IFRS 9 topics meriting enhanced transparency

The observations set out in this information note are based on a combination of IAASA's enforcement experiences[4], discussions with European accounting enforcers, and active engagement with the ESMA Financial Institutions Task Force[5] of which IAASA is a member.

IAASA believes that the following IFRS 9 topics merit closer consideration by preparers of banks' reports and closer scrutiny by users in interpreting those reports.

6.1. Significant increase in credit risk

IFRS 7.7.35F and IFRS 7.7.35G require entities to disclose the basis for the inputs, assumptions and the estimation techniques used to determine whether there is a significant increase in credit risk (SICR) of the financial instruments since initial recognition.

IAASA notes that banks provided a range of relief measures to borrowers. However, it is IAASA's expectation that banks will explain more clearly how these relief measures have impacted the assessment of SICR.

[4] In preparing this Information Note, IAASA did not seek explanations from issuers in relation to the movements in ECLs in issuers' periodic financial reports

[5] ESMA's Financial Institutions Task Force ('FITF') is a sub-group of EECS members with expertise in IFRS 9 and financial institutions in order to discuss the consistent application of IFRS 9

COVID-19 relief measures

ESMA's Public Statement[6] stated that pandemic related economic support and relief measures did not necessarily imply an automatic trigger for SICR. Therefore, where significant relief measures have been provided to borrowers and where those reliefs are withdrawn, IAASA expects that banks will distinguish between measures and reliefs that have an impact on the credit risk over the entire expected life of financial assets and those which address temporary liquidity constraints of borrowers. Banks should apply IFRS 9 accordingly in preparing their financial statements.

Operational simplification when assessing SICR

IAASA recommends that entities disclose how they have applied operational simplifications when assessing SICR for material sub-components of portfolios of financial instruments, such as using a 12-month risk as an approximation for change in lifetime risk [IFRS 9.B5.5.13] or assessing SICR at the counterparty level rather than at the level of the individual financial instrument.

Collective SICR assessment

Banks should ensure financial instruments that are grouped collectively for SICR assessment purposes should disclose the key credit risk characteristics forming the basis of their grouping. Banks should also explain how the collective assessment was performed (e.g. based upon a "bottom up" or "top down" approach) as well as any change in grouping compared to the previous reporting period.

Disaggregated disclosure of SICR thresholds

IAASA recommends that banks disclose disaggregated quantitative SICR-thresholds and provide additional explanations where there are significant differences in SICR thresholds (e.g. by material sub-portfolio). Banks should provide more granular level SICR information where it is material to an understanding of the SICR judgements.

6.2. Forward-looking information

IFRS 7.35G(b) requires disclosures about how forward-looking information (FLI) has been incorporated into the determination of ECLs. This includes the use of macro-economic information.

Macro-economic assumptions used in estimating the ECLs are likely to include:

(a) variables used in the calculation of ECL such as GDP growth, property price growth, unemployment rate, probability of default, loss given default and exposure at default

(b) explanations as to how the macro-economic scenarios were determined and changes therein

(c) scenario weightings, how they have been determined and changes therein, and

(d) significant differences in the application of the scenarios to individually and collectively assessed exposures and to different types of sub-portfolios.

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[6] https://www.esma.europa.eu/sites/default/files/library/esma32-63-951_statement_on_ifrs_9_implications_of_covid-19_related_support_measures.pdf

IAASA notes that some banks have stated that the COVID-19 pandemic has been considered in determining the macro-economic scenarios; however, only limited additional entity-specific information appears to have been disclosed in banks' periodic financial reports.

IAASA encourages banks to provide more entity-specific disclosures as to how the main judgements and estimations related to uncertainties have been taken into account when determining the macro-economic scenarios and macro-economic assumptions. Banks should also explain more clearly the methodology used to determine the scenario weightings and changes therein.

6.3. ECL post model adjustments (PMAs)

IAASA expects that, for each material PMA, the disclosures will provide detailed and entity-specific information about the rationale for the PMA, the impact of the PMA on the ECL estimate, and the methodology applied in determining the quantum of the PMAs [IFRS 7.35G, 35D and 35E of IFRS 7].

For example, in some instances it may be necessary for banks to explain in the notes to the financial statements that material adjustments are required to reflect the latest macro-economic outlook or to compensate for particular model limitations that fail to adequately capture selected risks. To enhance the usefulness of disclosures to users, IAASA expects banks to ensure that PMA disclosures are at an appropriate level of granularity, with an explanation of which specific type of products, sectors or other financial instrument characteristics the PMAs relate to.

IAASA notes that some banks provided detailed explanation of the rationale for material components of their ECL PMAs, however, few banks explained the methodology applied in the PMA calculation.

6.4. Explanation of changes in ECL allowances

IAASA acknowledges the improvements in explanation of changes in the ECL allowance by some banks in recent periodic financial reports.

IAASA notes that IFRS 7.35H and IFRS 7.35I requires disclosure of a quantitative reconciliation of movements on ECLs and a narrative explanation of the reasons for the movements in the ECL allowance during the reporting period.

IAASA notes that – in order to enhance transparency for users – banks' ECL loss allowance reconciliations should be disclosed both at the overall entity level and for each significant sub-portfolio with shared credit risk characteristics. The ECL allowance reconciliations should be accompanied by explanations of the nature of ECL movements, where those explanations are necessary to an understanding of the movements in the ECL allowance during the period.

IAASA expects that a clear understanding of the rationale for ECL allowance movements may become more important information for users of banks' periodic financial reports over time (i.e. as the impacts of withdrawing COVID-19 relief measures and supports are reflected in ECLs).

6.5. ECL sensitivity disclosures

IAASA acknowledges the improvements in the ECL sensitivity disclosures provided by some banks in recent Reports. However, IAASA strongly encourage banks to further improve the ECL sensitivity disclosures in the following areas:

(a) incorporate material post-model adjustments into ECL sensitivity disclosures

(b) disclose ECL sensitivities at a disaggregated level (such as by class of loan, geographic region or some other meaningful loan categorisation) where the sensitivities vary by material sub portfolios or are relevant to an understanding of the ECL sensitivity

(c) disclose ECL sensitivity to more than one input (e.g., sensitivity to house prices, GDP growth, loan type etc.) when it is necessary for an understanding of the ECL sensitivity

(d) disclose comparative data for ECL sensitivity disclosures, and

(e) describe the nature of the limitation(s) to the disclosed ECL sensitivities and the class of financial instruments to which each limitation applies.

IAASA encourage banks to disclose an explanation of reasons for the changes in ECL sensitivity and the reasons for material non-linearity in ECL sensitivity.

6.6. Climate risk and the impacts on ECL measurement

When preparing periodic financial statements, banks must consider whether the effects of climate risks are material to the financial statements.

To date IAASA has not observed any substantive reference in banks' periodic financial reports to their exposure to climate risk or how climate risk is incorporated into modeled ECLs.

IAASA expects banks to disclose whether or not material climate-related and environmental risks are taken into account in credit risk management, including information about the related significant judgements and estimation uncertainties in the future financial statements.

IFRS 7.35B requires entities (including banks) to disclose information to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. In this context, IAASA expects banks to disclose information about its climate risk exposure, if material, explain how climate risk is incorporated in the calculation of ECL, explain any climate risk concentrations and how those risks affect the amounts recognised in the financial statements. The level of detail disclosed by banks should be proportional to the materiality of the risk exposure i.e. more exposure to climate risk merits more detailed disclosures.

7. Conclusion

IAASA strongly encourages preparers, management, directors and audit committee members to:

(a) give detailed consideration to each of the topics set out in this information note when applying IFRS 9 and IFRS 7 in preparing periodic financial statements

(b) critically evaluate the rationale for and methodology used to calculate material ECL post model adjustments and why PMAs are not captured by ECL models

(c) consider how best to provide more transparency and decision useful information to users when explaining how they have applied IFRS 9

(d) strike an appropriate balance between providing enhanced transparency to users and overburdening the financial statements with excessive detail [IFRS 7.B3], and

(e) provide entity-specific disclosures on the impact of climate change and explain how ECLs are impacted by climate change.

Users of banks' periodic financial reports should carefully review and analyse the totality of expected credit loss information disclosed by banks and, in particular, information about:

(a) material post-model adjustments (management overlays)

(b) judgements surrounding significant increase in credit risk

(c) changes to forward looking information, and

(d) changes in expected credit loss allowances and expected credit loss sensitivities.

Appendix

Reference material

ESMA publications

https://www.esma.europa.eu/sites/default/files/library/esma32-63-951_statement_on_ifrs_9_implications_of_covid-19_related_support_measures.pdf

Describes the accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9 (25 March 2020)

https://www.esma.europa.eu/sites/default/files/library/esma32-63-1041_public_statement_on_the_european_common_enforcement_priorities_2020.pdf

Common enforcement priorities for the 2020 year end including IFRS 9 and IFRS 7

International Accounting Standards Board (IASB)

https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf

Educational material on the effects of climate-related matters on financial statements highlighting how IFRSs require entities to consider climate-related matters when the impact is material

https://www.ifrs.org/content/dam/ifrs/news/2019/november/in-brief-climate-change-nick-anderson.pdf

Article from IASB Board member on IFRS standards and climate related disclosures (November 2019)

IAASA financial reporting decision

https://www.iaasa.ie/getmedia/04e689e2-9d66-4478-b3d5-e297f82d774f/FRSU-Decisions-Publication-21feb20.pdf?ext=.pdf

IFRS 9 financial reporting decision (June 2020)

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