



Entering a “new normal” for IFRS 9 ECL  
measurement

Managing the Covid-19 impacts

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# Executive Summary

Without a doubt, 2020 will be marked in most people’s memory as the year when the Covid-19 virus arrived and changed our lives, the pandemic has created significant challenges on public health, the ways of living and working and the economy. Banks and credit risk management practitioners face a significant set of challenges to adapt IFRS 9 Expected Credit Loss (ECL) frameworks for the new normal.

In most banks, ECL models have led to stable impairment levels since the introduction of the IFRS 9 Standard in 2018. Due to the pandemic, banks are having to justify and explain impairment movements during a period of historically significant economic turmoil and uncertainty. The risks to impairment resulting from Covid-19, have been recognized by regulators who, through the crisis, have provided banks with guidance relating to credit risk identification and measurement. Management teams are having to adapt to the new reality, with enhancements to IFRS 9 ECL models and processes needed. With programmes to repair and refine Internal Rating Based (IRB) credit risk models being finalised, the challenge will be to find the right mix of management adjustments, back-testing, recalibration and redevelopment with available resources.

This document is addressed to decision-makers and credit risk practitioners and discusses the main implications of the Covid-19 pandemic relating to IFRS 9 ECL measurement. For example, in some firms, ECL model outputs have been either too responsive or not responsive enough to the new economic environment and credit risk outlook. We assess how credit risk models (and processes) that were built and implemented pre-Covid-19, have ceased to work effectively and how IFRS 9 ECL model monitoring and measurement techniques need to evolve. Further, we explore how government support measures (including payment moratoria) have reduced the responsiveness of credit risk metrics and the rating systems, creating new data availability, representativeness and timeliness challenges.

We set out how leading banks are seeking to address the challenges faced and meet regulatory expectations. In the short term, the credit risk outlook and impacts of the crisis (in terms of observed credit outcomes) remains highly uncertain, with increased use of top-down and bottom-up management overlays for ECL expected to continue. The processes and controls used to capture and substantiate this expert judgment need to be strengthened, with a clear exit strategy to avoid long term reliance on management overlays. In the medium term, change programmes are likely, to adapt and enhance data sourcing and infrastructure, plus methodological approaches and techniques, available for ECL model development, maintenance, implementation and use.

“It is crucial that significant institutions strike the right balance between avoiding excessive pro-cyclicality and ensuring that the risks they are facing (or will face) are adequately reflected in their internal risk measurement and management processes, financial statements and regulatory reporting (ECB, 4 Dec 2020).”

# Data Requirements

In trying to protect public health, the response of governments to the Covid-19 pandemic included a series of economic lockdowns. This created pressures for individuals and businesses due to make payments on credit obligations resulting in both legislative and non-legislative obligor protection schemes. This has led to new data availability and collection challenges for credit risk management in banks in this new economic and legal environment.

## IFRS 9 Standard Requirements

In accordance with IFRS 9 paragraph 5.5.17 ECL measurement should reflect reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. This includes the timely collection of data for stage allocation purposes (e.g. financial information used for identifying a Significant Increased in Credit Risk (SICR) in a corporate borrower).

## Deloitte Insights

Data sourcing and management is a priority, for identifying and quantifying credit risk, in order for banks to make sound credit risk decisions. The new reality forces banks to collect and store new data (e.g. data associated with government support) which can heavily impact Stage 2 and Stage 3 triggers plus ECL measurement. As a result of the crisis, critical data has become less reliable (e.g. days past due, payment behavior and consumption patterns), changed quickly (e.g. employment status and disposable income) or appeared for the first time (e.g. reliance on moratoria and support schemes).

The absence of consistent behavioural information and lagging information (e.g. financial information for corporate and small business borrowers) has created a “latent credit risk”, delaying timely ECL measurement and stage allocation. The approach to mitigate these weaknesses has varied across Europe, ranging from front-loading credit rating changes via rating overrides, spreading the ECL impact at a portfolio or segment level via management overlays and post-model adjustments (PMAs), or doing nothing. Leading banks are expected to effectively identify, capture, store and use granular additional information from the crisis, both in a structured and unstructured format. This data should be available and used to inform i) credit risk performance analysis and accurate monitoring of credit risk portfolios and ii) ECL model backtesting, calibration and adjustment. Leading banks are likely to have the infrastructure needed to efficiently aggregate, report and analyse credit risk data on an agile basis, such that management can formulate timely and appropriate responses to changes in credit risk outcomes, at a micro and macro level.

## Regulatory expectations

“The ECB has highlighted challenges posed by the absence of behavioral information and lack of representativeness of financial information for the purposes of default identification and rating assignment, plus the need for banks to use current information and enhanced methodologies for capturing idiosyncratic client characteristics in the measurement and monitoring of credit risk.”

# Identifying SICR

Traditional mechanisms for identifying Significant Increase in Credit Risk (SICR) have ceased to work effectively during the pandemic, given the lack of timely information regarding backstop indicators (e.g. days past due triggers), reduced confidence in PD model performance and forbearance triggers requiring special treatment of payment holidays associated with Covid-19 moratoria.

## IFRS 9 Standard Requirements

IFRS 9 paragraph 5.5.9 requires SICR identification to reflect a comparison of the default risk at reporting date with the default risk at the date of initial recognition, per financial instrument (i.e. a change in lifetime PD). The assessment should be based on a set of quantitative, qualitative and backstop indicators. Whilst payment deferrals related to Covid-19 measures could easily trigger SICR assessments, policy makers have guided banks to not always regard Covid-19 measures as good indicators of SICR, credit impairment or default, to mitigate overly procyclical outcomes.

## Deloitte Insights

Where IFRS 9 stage allocation data is lacking, delayed or outdated, banks will need to enhance and supplement current approaches to allow for the timely identification of SICR. As Covid-19 support measures come to an end, during 2021, forbearance policies are expected to be increasingly relied on. Where the borrowers do not resume payment obligations in full, forbearance is expected to be considered an indicator of SICR, supported by expert judgement.

Leading banks should review the PD models used to inform bottom-up SICR identification, with back-testing designed to ensure associated PD thresholds remain relevant versus an agreed measure of “successful Stage 2 outcomes”. Top-down SICR analysis is expected to continue, using macro-economic and sector specific analysis to anticipate the evolution of problem loans. Leading banks are expected to supplement portfolio analysis with individual assessment of large exposures, aiming to systematically differentiate liquidity issues versus credit risk increases, caused by the reduced operational resilience of clients.

The Covid-19 pandemic has provided a unique learning opportunity for IFRS 9 practitioners with leading banks applying both short, and medium term, solutions as part of a holistic response to address SICR challenges. Covid-19 vintage loans will need specific attention, such that future deterioration in credit risk can be detected. Further, the use of new and disruptive methods, such as unsupervised learning techniques, could be considered to advance the accuracy of SICR identification using new sources of (unstructured) data.

## Regulatory expectations

“Significant increases in credit risk should be identified on a timely basis in order to ensure adequate levels of provisions. With regards to loans under payment moratoria complementary Stage 2 triggers should be assessed more comprehensively. Smoothing stage transfers should be avoided.”

# Parameter Estimation

The performance of parameters (from PD, LGD and EAD models) used to estimate ECL is expected to deteriorate following the global pandemic. Default and loss outcomes are only slowly being observed, but with model parameters built on pre-crisis default and loss history, the absence of relevant risk drivers (e.g. payment moratoria) in the existing models is expected to result in parameters becoming increasingly unintuitive.

## IFRS 9 Standard Requirements

IFRS 9 paragraph B5.5.18 sets out that ECL could include information from the statistical models or credit ratings processes used by a firm. Parameter estimates generated by such models and processes, and often are used as components within the ECL, rely on up-to-date information being available, relevant and unbiased. Covid-19 has reduced the reliability of input data and the consistency of calibration data, increasing the risk of bias in parameters without adjustment.

## Deloitte Insights

Most firms estimate and calibrate parameters using historical default and loss data series, with model fitting influenced by the outcomes of earlier downturn periods (e.g. the Financial Crisis of 2008). Practitioners seeking to validate and understand ECL movements, will need to assess models and parameters, as outcome data arrives in 2021 and beyond. The impact is expected to vary greatly across segments. Leading banks should seek to identify and understand model risks by monitoring parameters in high risk segments. Sources of bias identified will be mitigated via in model adjustment, parameter recalibration or post model adjustments. Leading banks are likely to use a range of tools to anticipate model performance reduction (including what-if analysis to test and stress model outcomes under different circumstances) to inform expert judgment.

Experience from previous crises (e.g. Irish or Greek financial crises in 2008/2009) suggests that changes in the external environment (e.g. introduction of legal moratoria suspending mortgage property sale and repossession) could be anticipated as the model landscape evolves. For example, models that can incorporate expert judgment over long and uncertain outcome periods post default could be increasingly used (e.g. structural LGD models explicitly capture the level and quality of underlying collateral, plus time to sale assumptions). Leading banks are expected to apply such tactical solutions within the context of a holistic credit risk measurement strategy. Banks with a clear roadmap, that sets out how tactical solutions fit within model remediation in the context of changes to the strategic model landscape (e.g. including the connections between IRB, IFRS 9 and stress testing) are expected to deliver change most efficiently.

## Regulatory expectations

“Regulatory guidance suggests the timely recognition of Covid – 19 effects and corresponding relief measures in rating assignment process is required through revision of Loss Given Default (LGD) and Credit Conversion Factors (CCF) in order to eliminate the need for a “huge upwards revision” at a later stage.”

# Forward Economic Guidance

While macro-economic forecasting has always been a challenging endeavour, the Covid-19 pandemic has created new challenges, not only for forecasting the economic environment, but also for estimating the state of the economy in the new normal and how this relates to credit loss distributions. As increased levels of uncertainty remain, the question will be how institution-specific expectations should best be accounted for in the measurement of ECL.

## IFRS 9 Standard Requirements

IFRS 9 requires a forward-looking view of credit risk in which a range of possible outcomes should be considered to measure a probability weighted ECL. The ITG<sup>1</sup> highlighted that a compliant methodology should reflect the non-linear relationship between forward-looking scenarios and associated credit losses, with specific circumstances, geographical and risk features of each portfolio accounted for.

## Deloitte Insights

Throughout the Covid-19 year, European policy makers have encouraged banks to use long-term macro-economic forecasts as a means of avoiding procyclicality and mitigating cliff effects in ECL measurement. Most banks have anchored baseline scenarios to ECB forecasts, although many of them have struggled to capture first and second-order relationships between the macro-economy and credit losses. Leading banks have sought to analyse a range of potential macro-economic outlooks (e.g. V-shaped, U-shaped, L-shaped or K-shaped) and used analysis of sectoral or idiosyncratic specific risks (e.g. relating to specific industries and segments expected to struggle) to inform management overlays.

Practices across Europe varied during 2020, as banks sought to cope with sudden movements in the economic outlook and the increased uncertainty. All banks updated their macroeconomic forecasts whilst some changed weights (e.g. increasing the probability of downside scenarios) or introduced additional scenarios, to capture the downside risk in the ECL measurement. To support the selection of scenarios and weights, understanding the relationship between macro-economic forecasts and ECL has, become increasingly important. Most banks have continued to use existing frameworks to design and select scenarios and weights. Leading banks have developed and used monitoring frameworks to test and substantiate choices, with the weights of each scenario tested relative to the credit loss distribution, to ensure the final impairment remains an unbiased probability weighted expectation of loss.

## Regulatory expectations

“Baseline scenarios for IFRS 9 should be anchored on central government macroeconomic forecasts, in an unbiased manner. Where reliable macroeconomic forecasts for specific years are available, institutions should take them into account in order to mitigate cliff effects and limit procyclicality.”

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<sup>1</sup> ITG meeting summary 11 December 2015

# Management Overlays

Formulating a response to the challenges posed in measuring ECL during the Covid-19 pandemic required firms to increase the use and reliance on management overlays given the environment of increased uncertainty and a limited view on risks in the portfolio.

## IFRS 9 Standard Requirements

IFRS 9 requires the use of top-down and bottom-up approaches for ECL measurement in cases where it is not possible to conduct credit assessments on an individual basis due to lack of client-specific information. Capturing expert credit judgment is therefore key at both segment and portfolio level.

## Deloitte Insights

Most banks have expanded the frequency and scope of management overlays for impairment, as a result of Covid-19. The increased use of management overlays has highlighted gaps in governance and controls required to ensure ECL estimation is measured consistently across portfolios and over time. Across Europe, different maturity levels are observed in management overlay frameworks. Leading banks offer a clear link between underlying model limitations and/or reasons for adjustment and each management overlay. Each model overlay is justified and subject to independent challenge, with clear criteria established for the overlay to reduce or change over time.

Post-model adjustments (PMAs) are a specific sub-set of management overlays, including targeted recalibration, additional mini-models or specific expert-based assumptions. PMAs offer a short-term fix to ECL calculations, whilst model recalibration and rebuild options remain limited. Policy makers are rightly pushing firms to remediate the root causes of PMAs, by enhancing models. Where this cannot be done in a timely manner, the monitoring, analysis and documentation of PMAs will retain a central role in the ECL control framework. Leading banks are expected to actively manage the portfolio of PMAs, keeping the scope, duration and conditions for unwinding management overlays under regular review.

Practitioners and decision-makers need to understand that PMAs do not eliminate the requirement to improve models in the long term. Management overlays increase the reliability of ECL impairment levels in the short term. Over-reliance on PMAs in the long term creates costs and regulatory risks which are neither sustainable, nor justifiable. Leading banks are establishing model development plans to enhance the granularity and sophistication of IFRS 9 ECL model suites, to address model limitations uncovered by the crisis.

## Regulatory expectations

“Management overlays should be directionally consistent with observable macroeconomic variables and forward looking forecasts. Overrides of established quantitative approaches should generally be permitted if it is applied at the most granular level possible and are subject to robust governance and validation procedures.”

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