From a ‘New Normal’ to ‘Normal’

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IASB Guidance

- It is likely to be difficult at this time to incorporate the specific effects of Covid-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings.

- If the effects of Covid-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available.

- Indeed, in the current stressed environment, IFRS 9 and the associated disclosures can provide much needed transparency to users of financial statements.

- We have been closely engaged with many prudential and securities regulators and others regarding the application of IFRS 9 in the context of the Covid-19 pandemic.

Guidance from Regulators

- Competent authorities should make full use, where appropriate, of flexibility embedded in existing regulation (EBA 12th March 2020)
- In ESMA's view, the principles-based nature of IFRS 9 includes sufficient flexibility to faithfully reflect the specific circumstances of the Covid-19 outbreak and the associated public policy measures. Issuers and their auditors should take this Public Statement into due consideration. Whilst this statement addresses solely financial reporting aspects, ESMA has coordinated with the European Banking Authority (EBA) which issued a statement on the prudential framework in light of Covid-19 measures on 25 March 2020. Both statements are consistent as regards financial reporting.
- ESMA considers that issuers should carefully assess the impact of the economic support and relief measures on recognised financial instruments and their conditions.
- In particular, ESMA notes that the measures taken in the context of the Covid-19 outbreak which permit, require or encourage suspension or delays in payments, should not be regarded as automatically having a one-to-one impact on the assessment of whether loans have suffered a SICR.
- ESMA notes that if reasonable and supportable information that is more forward-looking than information on the past due status of the concerned exposures is not available without undue cost or effort (either on an individual or a collective basis), issuers may use past due information to determine whether there have been significant increases in credit risk since initial recognition.
- Finally, in ESMA's view, when making forecasts, issuers should consider the nature of this economic shock (i.e. whether the Covid-19 effect is expected to be temporary) and the impact that the economic support and relief measures (including debt moratoria) will have on the credit risk over the expected life of the instruments, which include, depending on the instruments' maturities, longer-term estimates.

  (ESMA 25th March 2020)

ECL Measurement under Covid-19

Covid-19 impact on provisions

- **FY20** ECL coverage ratios increased across the three ECL stages in FY20.

The UK banks' results in FY20 are in contrast to EU banks', where overall ECL coverage ratios (average) remained flat year on year. Specifically, the ECL coverage ratio for stage 2 has fallen despite higher stage 2 exposures in EU banks.

- **Q1 21** saw a decline in the ECL coverage ratios in Q1 21, although they remained higher than pre-pandemic levels. The reduction in coverage ratio is attributed to improvement in PDs reflecting more positive economic forecasts.

(KPMG)

Disclosures – Impact of Covid-19

In UK and EU Banks provided increased disclosures for the main areas of focus and the impact on ECL as a result of the pandemic, using different approaches to provide the relevant disclosures (e.g., graphs, tables, narrative). Banks have provided a significant amount of information in their quantitative and qualitative credit risk disclosures.

Increase, or improvement, in the disclosures provided in the following areas:

- ECL charge and Cost of risk2 – in particular, in relation to Stages 1 and 2, which have become more prominent
- Analyses by sector including those most vulnerable to the impact of Covid-19
- Forward looking scenarios – description of scenarios, weights and how banks have incorporated the impact of support measures
- Sensitivity analyses

(EY)

The same cannot be said for all jurisdictions.

Model Adjustments or Overlays

Given the degree of uncertainty surrounding the economic impact of Covid-19 and the lack of reliable data to model the impact on the banking book, as well as the operational and timing challenges in incorporating the latest available macroeconomic inputs into the ECL models, it was expected that banks would include overlays and model adjustments in their ECL provision.

FY20:— The level of provisions using adjustments booked as a percentage of total ECL allowance ranged vastly amongst banks, ranging from 3% to 28% for UK banks in FY20, which is significantly higher than FY19.

Q1 21:—UK banks have mainly carried forward the PMA applied at Q4 20, making marginal adjustments to the overlay amount in Q1 21. PMA as a percentage of total ECL allowance in Q1 21 is higher than FY20 because of the lower ECL allowance in Q1 21.

(KPMG)

PMA – Post Model Adjustments

Model Adjustments / Overlays Disclosures

A number of banks provided additional quantitative and qualitative disclosures in respect of overlays and post-model adjustments in their ECL provision, which ranged from detailed information, including the impact on different portfolios, to narrative only.

Based on disclosures provided, the total of the post-model adjustments and management overlays, both in absolute terms and in terms of their proportion to the total of Stage 1 and Stage 2 ECL allowance, was significant.

(EY)

Example - Kompanion Bank Closed Joint-Stock Company

As at 31 December 2020, the Group introduced certain changes in its process of estimation of expected credit losses in the context of the ongoing Covid-19 pandemic. In particular, it has revised indicators of significant increase in credit risk and does not automatically consider the credit risk to have significantly increased in the case of a loan modification being part of the government support measures. The Group considered loan modifications provided under government support measures as an indicator of significant increase of credit risk only if a borrower had overdue days over 30 days or more during the past 180 days. The Group also updated forward looking information, including forecasts of macroeconomic indicators and scenarios' weights. The Group applied post-model adjustments to appropriately reflect the uncertainty associated with the spread of Covid-19 pandemic.

Post-model adjustments and management overlays made in estimating the reported ECL as at 31 December 2020 are set out in the following table:

	Modelled ECL	Post-model adjustments	Total ECL	Adjustments as a % of total ECL
Microlending	178,022	85,019	263,041	32.3%
Small and medium business lending	59,624	57,129	116,753	48.9%
Consumer Lending	34,662	27,178	61,840	43.9%
Total	**272,308**	**169,326**	**441,634**	**38.3%**

Example - Barclays

Overview of Management Adjustments to models for impairment (audited)

	2021		2020	
As at 31st December	Management adjustments to impairment allowances	Proportion of total impairment allowances	Management adjustments to impairment allowances	Proportion of total impairment allowances
	£ Millions	%	£ Millions	%
Home Loans	**34**	**8.8**	54	12.4
Credit Cards, unsecured loans and other retail lending	**966**	**40.4**	960	31.3
Wholesale Loans	**142**	**11.6**	-78	-3.3
Total	**1,142**	**28.6**	**936**	**16.0**

Scenarios

For the purposes of their annual financial statements for 2020, in certain jurisdictions banks have significantly adjusted the economic assumptions applied and disclosed in 2019 in respect of forward-looking information, to reflect the development of the pandemic.

Banks generally provided extensive information – both quantitative and qualitative – to explain the changes they made in their models, assumptions, forecasts and scenarios.

In addition to the disclosures provided in their audited financial statements, banks provided additional analysis and information regarding the development of these changes and their impact on a quarterly basis in the other sections of their annual reports and in the presentations to investors and analysts.

However, diversity in practice was noted in relation to the number of scenarios used, the weights assigned to them and method of presentation employed by each bank.

(EY)

Again, the same cannot be said for all jurisdictions.

Supervisory Challenges – Way Forward

Sound Governance

A sound governance framework, including effective challenge, is fundamental to all aspects of a bank’s ECL estimation process.

Many banks lagged in implementing a sound governance framework.

Especially relevant given the relaxations provided and is the first step in the ensuring there is a path back to normal.

Model Adjustments / Overlays

Model adjustments using experienced credit judgment

It is important that banks use their experienced credit judgment to compensate for core model limitations through model adjustments.

Prudential concerns arise, however, where banks are:

(i) over-relying on model adjustments for significant credit risk factors that can be incorporated into core models without a disproportionate effort

(ii) not working in a timely way to remove the need for temporary adjustments; and/or

(iii) failing to ensure the completeness of model adjustments necessary to compensate for model and data limitations.

Renegotiations / Forbearance

Classification of assets under Forbearance / Renegotiations

There are deficiencies observed regarding the policies used by banks for determining the staging of such assets.

In addition, policies regarding treatment of such assets as POCI is unclear.

Refinance risk – impact on ECL measurement and staging for loans with bullet and balloon repayments

Not all banks are considering refinance risk when estimating ECL, which could result in understatements of the ECL estimate and/or delays in transferring exposures to lifetime ECL measurement. Refinance risk is particularly relevant to loans with significant repayments due at maturity, such as bullet and balloon loans, which are common in some jurisdictions.

Use of minimum continuous repayment periods (probation or cure) as criteria to move exposures back to stage 1 or from stage 3 to stage 2

Different approaches have been observed among banks regarding the use of minimum continuous repayment periods to restrict when exposures can move back to stage 1 (probation period) or from stage 3 to stage 2 (cure period). While not all banks have specific accounting policies on the matter, some banks define a minimum probation or cure period for forborne or restructured exposures only while others apply a probation or cure period to all exposures.

SICR

Consideration of qualitative and quantitative factors including forward-looking information

In addition to quantitative factors, the significant increase in credit risk (SICR) assessment should also consider a comprehensive set of qualitative indicators.

Range and choice of thresholds used for the timely recognition of lifetime ECL measurement

Banks use a wide range of thresholds to assess whether SICR has occurred, which has the potential to negatively impact the comparability of the ECL estimate across banks. Where assumptions used by an entity are inconsistent with those of its peers, this should result in a closer analysis and an application of scepticism by supervisors on whether banks' assumptions are reasonable and supportable.

Further risks arise when banks rely solely on thresholds associated with lagging indicators (rather than more forward-looking indicators which are encouraged by IFRS 9). Examples of lagging indicators include: using 30 days past due as a primary indicator of SICR.

Thresholds that result in a late identification of SICR (eg assigning a large change in PD as a trigger for SICR); or using 12-month PDs as an approximation of lifetime PD for exposures when significant cash flows are concentrated at a point in time beyond 12 months.

Use of Scenarios

Range of economic scenarios in ECL measurement and banks' calibration of probability weights

Approaches to modelling economic scenarios vary across banks, as do the severity of scenarios and probability weights assigned. Prudential concerns arise if the range of economic scenarios is overly narrow – such that ECL does not capture the full extent of non-linearity – or if probabilities are misassigned such that the range of scenarios effectively functions as a single scenario. This can occur, for example, when excessive weight is given to the base case scenario or when insufficient consideration is given to low-probability, high-impact scenarios.

Timing

Clarity regarding the timing of withdrawal of relaxations

Clear communication and setting of expectations regarding any withdrawal of relaxations in the future as the pandemic recedes in impact along with Government support and relief measures.