IFRS 9 Overlays and Model Improvements for Novel Risks

Description

In this document, the ECB is focusing on the challenges banks face in incorporating novel risks into their IFRS 9 expected loan loss provisioning frameworks. It addresses the ongoing appearance of risks such as health crises, geopolitical tensions, climate change, and economic instability, which traditional models fail to capture adequately. The document emphasizes the critical role of overlays—post-model adjustments—in quantifying these risks and highlights the need for sound governance, robust methodologies, and transparent processes. It also describes the deficiencies in current risk quantification, stage transfer methodologies, and governance practices, calling for enhanced forecasting capabilities through simulations and scenario analysis. Ultimately, the document outlines the ECB's ongoing supervisory efforts to ensure banks' resilience and compliance with IFRS 9 principles in the face of evolving risk landscapes.

Overview

The document opens with an acknowledgment of the continuous emergence of new risks, emphasizing the importance of accurate risk assessment in banking. The COVID-19 pandemic significantly influenced the way banks perceive and manage risks, showing how health-related events can impact borrowers' solvency. Alongside health risks, other emerging threats include energy supply disruptions, geopolitical tensions, high inflation, rising interest rates, and climate change. These risks pose a challenge for banking supervisors, who traditionally rely on historical data to predict and manage risks.

To better manage these challenges, the ECB Banking Supervision has turned to forward-looking supervisory tools and regulatory measures, with a particular focus on IFRS 9 expected loan loss provisioning. IFRS 9, a principles-based accounting standard, necessitates the incorporation of forward-looking information into loan loss provisions. This approach impacts prudential capital ratios and acts as a safeguard against novel risks. In November 2022, the ECB initiated a targeted review involving 51 banks to assess how their IFRS 9 provisioning frameworks capture emerging risks. This review was aimed at ensuring that banks are adequately prepared to manage these risks and maintain financial stability

Key Topics

A) The Continued Prominence of Overlays

The study discusses the use of overlays, or management adjustments, to quantify emerging risks that current models cannot fully capture. During the COVID-19 pandemic, the use of overlays became widespread due to the lack of relevant historical data. Despite expectations that their use would diminish as more data became available, overlays remain significant due to the persistent complexity of novel risks.

Key Findings

Key findings from the review indicate that overlays are critical in ensuring that banks adequately capture these risks. Specifically:

- Overlays have been used to address gaps in existing IFRS 9 models.
- The review found that many banks still rely heavily on overlays due to insufficient model sensitivity to new risks.
- The ECB emphasizes the need for sound analysis, robust governance, and transparent processes to justify overlays.
- A significant number of banks, however, lack sufficient documentation and justification for their overlays, pointing to weaknesses in risk management frameworks.
- 80% of banks reported using overlays for COVID-19 related risks.
- Around 60% of banks continue to rely on overlays for other novel risks, such as geopolitical tensions and climate change impacts.
- The average overlay adjustments across banks range from 10% to 20% of total provisions.

An increasing number of banks (12-21%) rely on legacy macro-overlay models, which the ECB criticizes for their lack of sensitivity to novel risks and inability to differentiate nuanced sectoral impacts. This practice is contrary to ECB's recommendations for a more robust approach.

B) Consideration of Novel Risks: Mainly the Issue of Laggards

The review identified variability in how banks consider novel risks. Some banks effectively use overlays to capture these risks, while others overly depend on outdated IFRS 9 models that are not sensitive to current novel risks, leading to systematic underestimations of risk impacts. The ECB expressed concerns about this reliance on outdated models and has plans for further supervisory actions against banks that fail to adequately address novel risks.

Key Findings

Specific issues highlighted include:

- A significant portion of banks (approximately 40%) still rely on pre-COVID-19 model parameters.
- Many banks fail to integrate forward-looking information adequately, which is crucial for anticipating the impacts of novel risks.
- There is an over-reliance on macroeconomic scenarios that do not fully capture the breadth and depth of novel risks
- 53-76% of banks use overlays, while a smaller percentage (2-10%) use in-model adjustment.
- 12-21% of banks still rely on legacy macro-overlay models to capture novel risks, which fails to meet ECB's recommendations.

C) Specific Considerations for Long-Lasting Novel Risks

Particular attention is given to long-lasting novel risks, such as climate and environmental (C&E) risks, geopolitical risks, and interest rate risks for commercial real estate (CRE) portfolios. These risks are challenging to measure and affect banks in the long term. As a result of the first targeted IFRS 9 review and other initiatives in this area, C&E risks are now considered by a majority of banks (55%), up from 16% in 2023. This is a big improvement but not yet fully satisfactory.

Key Findings

33% of banks do not consider C&E risks and 12% of banks state that the macro-components of their IFRS 9 models already consider C&E risks (indirectly) through the general forward-looking scenarios (e.g., the effect of C&E risks on GDP forecasts). This approach lacks all necessary risk sensitivity and does not ensure risk differentiation between debtors that are unevenly affected by C&E risks in general.

- Climate and environmental risks require substantial investment in data collection and model development. Only 25% of banks have fully integrated C&E risks into their IFRS 9 models.
- Geopolitical risks are less frequently modelled, with less than 20% of banks having specific overlays for these risks.
- Interest rate risks, especially for CRE portfolios, are critical due to their long-term nature. Over 50% of banks identified interest rate risk as a significant factor but lack robust methodologies to measure its impact accurately.

Some banks use models or simulations to consider different scenarios, while others account for C&E risks in credit ratings through qualitative elements. Slight increase in the use of overlays and in-model adjustments (63% and 4%, respectively), but many banks still use outdated approaches, underestimating the impact of geopolitical risks.

Good practices include simulations of probability of default/rating effects by stressing the financial figures of counterparties subject to high interest rates, and simulations of probability of default/loss given default effects coming from further falls in collateral valuations.

D) Quantification, IFRS 9 Stage Transfers & Governance

The review assessed the quantification methods, stage transfer methodologies, and governance processes related to IFRS 9. It found significant deficiencies in these areas:

- **Stage Transfers:** Many banks use umbrella overlays that apply lifetime losses to broad sectors without proper differentiation. Around 45% of banks use such broad-based approaches.
- **Quantification:** Some banks lack robust quantification methods for novel risks. Approximately 30% of banks do not perform sensitivity analyses to gauge the impact of novel risks.
- **Governance:** There are notable governance shortcomings, with about 35% of banks lacking clear documentation and approval processes for overlays.

The ECB stresses the need for enhanced methodologies and stronger governance to ensure adequate risk coverage including developing more granular and risk-sensitive stage transfer criteria, ensuring overlays are based on detailed and transparent analyses and strengthening governance structures to ensure oversight and accountability in the provisioning process.

Key Findings

- Most banks struggle to capture novel risks in statistical models due to insufficient data.
- Banks with robust governance frameworks tend to have more accurate and timely adjustments, reducing under-provisioning risks.
- Around 60% of banks with well-documented governance processes reported fewer issues with stage transfers and quantification inaccuracies

Widespread bad practices include considering novel risks only via their aggregate impact on future GDP and ignoring their impact on IFRS 9 staging. Banks with poor practices have lower provision coverage on average. Financial reporting functions need clearer responsibilities and involvement to reflect IFRS framework properly.

A common bad practice is the use of overlays at the total ECL level, and the ECB recommends banks not to use this practice: "Banks using "overlays at the total ECL level" did not reflect the risks driving ECL overlays in their Stage 2 classification. This practice is not just contradictory, but it also leads to insufficient risk coverage". Similarly, overlays at the total ECL level are not in line with the principles of IFRS 9, which require capturing all identifiable risks also in probabilities of default and thus staging.

Conclusion

The document concludes with key recommendations for banks to enhance their IFRS 9 frameworks and manage novel risks effectively. Banks should improve forecasting capabilities through simulations and scenario analysis, using diverse macroeconomic scenarios to capture a wide range of potential outcomes. It is essential to develop and regularly update well-justified overlays, ensuring they are documented and approved through proper governance. Incorporating forward-looking information into risk models and provisioning frameworks is crucial, making it an integral part of risk management rather than an add-on. Banks should also adopt more granular quantification methods and perform sensitivity analyses to understand risk impacts across different segments. Strengthening governance structures with clear documentation and independent reviews is important for maintaining integrity. Focus should be on long-lasting risks like climate change and geopolitical tensions, with investment in data collection and collaboration with external experts. Continuous improvement in risk management practices, staying updated with regulatory and industry trends, and adapting strategies to evolving risks are vital. The ECB will continue to guide banks in refining their IFRS 9 frameworks to ensure financial stability and effective risk management.