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IFRS 9: The ECB puts aspects of credit risk provisioning to the test

Banks should identify new risks more quickly and adapt calculation methods

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Key facts:

- The European Central Bank (ECB) report highlights that banks may have insufficient provisions for new, short-term and long-term risks
- The report calls for action in several areas
- Institutions should also sharpen IFRS 9 stage allocation based on the ECB's recommendations

Geopolitical risks and structural economic crises have increasingly shaped the banking environment.

From the COVID-19 pandemic to the wars in Ukraine and the Middle East subsequent inflation and interest rate developments, banks have faced an escalating frequency of disruptive events. But how well do banks account for these novel risks in their credit risk provisioning?

The ECB addressed this question in its report on 'IFRS 9 Overlays and Model Improvements for Novel Risks'. The results show progress in some areas, but also suggest that many banks continue to make insufficient-or in some cases, no-additional risk provisions for novel risks. This raises concerns that credit losses and capital requirements might be underestimated due to inadequate processes.

ECB calls for improvements in several areas of risk provisioning

In its supervisory authority, the ECB has examined the financial reporting of credit institutions on the basis of the International Financial Reporting Standard 9 (IFRS 9) of the International Accounting Standards Board. For the ECB, the findings are less than satisfactory.

The ECB identifies the following key areas requiring improvement:

- Identifying the novel risks with an impact on risk provisioning based on comprehensible banking processes and methods
- Quantifying the effects on the basis of models that are not lacking sensitivity and differentiation to novel risk exposures and that are not only based on macroeconomic time series not reflecting new impacts driven by novel risks in the current situation - banks should take into account individual portfolio circumstances and characteristics

- The consideration of risks in IFRS 9 risk provisioning and stage allocation for both individual transactions and especially for collective stage allocation

How should banks respond?

We see the need for a comprehensive governance as a key challenge. A robust governance framework is essential to reliably identify emerging risks and to develop scenario-based methods for quantifying risk provisions. The ECB highlight this as a significant gap in many institutions.

Cross-divisional cooperation is essential, especially for the annual financial statements

In practice, a cohesive risk assessment can only be achieved through consistent risk evaluation across various market departments, finance, and economic forecasting. Efficient and targeted cooperation between these areas is crucial, especially during – but not limited to – year-end closing.

Correct credit risk provisioning : Criticism of the stage allocation

The quantification of a risk that has just occurred on the level of credit risk provisioning must be based on meaningful simulation calculations in this process taking into account consistently all available information throughout the bank. This necessitates a robust, simulation-capable infrastructure of tools and evaluation options.

For instance, when a geopolitical risk arises, the relevant exposures must be identified, and their risk profile adjusted promptly. This underscores the ECB's criticism of stage allocation under IFRS 9: Financial institutions that experience a significant increase in credit risk identified in risk management must be disclosed in stage 2, with appropriate risk provisions.

If a geopolitical risk impacts an entire class of exposures with a specific risk profile, these exposures may have to be assigned collectively to stage 2.

Flat-rate adjustments and earnings management

From an IT systems perspective, risk provisioning must remain adaptable and customizable. It is also advisable to separate different risk management channels (ICAAP, pricing etc.) at parameter level to prevent risk provisioning adjustments from directly impacting other management metrics, such as risk-weighted assets (RWA).

Lastly, the ECB raises concerns about the connection between overlays – i.e., general adjustments – and earnings management. While overlays are not inherently problematic, the ECB's caution suggests they could be used as tools for earnings management.

The ECB will continue to monitor banks and take supervisory action to ensure adequate processes and credit risk provisioning for novel risks, from identification to correct accounting. Only adequate consideration of novel risks will ensure adequate risk provisioning.

The bottom line: Banks should promptly reassess their approaches to handling novel risks and evaluate their alignment with the ECB's expectations. With year-end approaching, time may be running out for necessary technical adjustments. Failure to act could draw the attention of supervisors, potentially resulting in special audits.