IFRS 9 audit

Setkání interních auditorů z finančního sektoru

23 November 2021
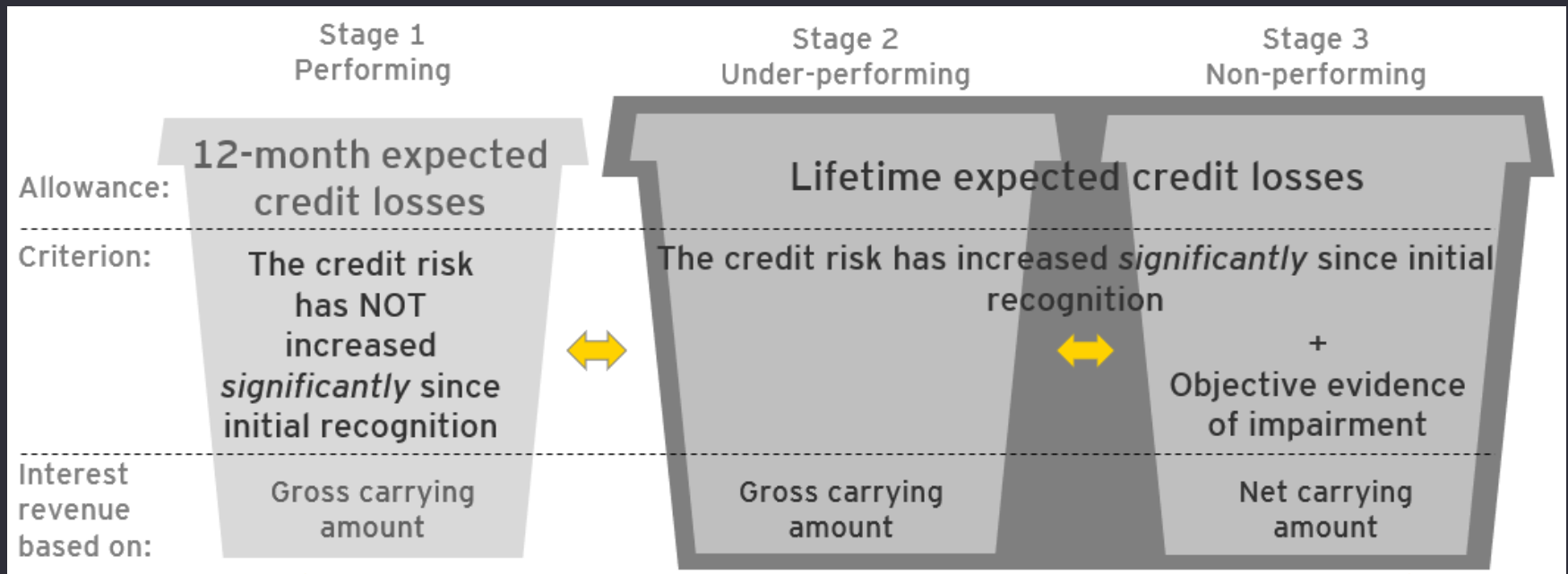
Agenda

1. IFRS 9 staging
2. ECL calculation
3. Forward looking adjustments
4. Q&A

EY

Staging - introduction

- Each reporting date accounts are distributed to 3 stages:
  - Stage 1 – no significant increase in credit risk since initial recognition
  - Stage 2 – significant increase in credit risk since initial recognition
  - Stage 3 – defaulted accounts

	Stage 1 Performing	Stage 2 Under-performing	Stage 3 Non-performing
Allowance:	12-month expected credit losses	Lifetime expected credit losses	
Criterion:	The credit risk has NOT increased *significantly* since initial recognition	The credit risk has increased *significantly* since initial recognition	+ Objective evidence of impairment
Interest revenue based on:	Gross carrying amount	Gross carrying amount	Net carrying amount

EY

Staging - Significant Increase in Credit Risk

- Bank should assess the change in the risk of default by comparing the risk of default as at the reporting date with the risk of default as at the date of initial recognition
  - Lifetime PD should be compared according to IFRS 9
  - Rebuttable presumptions of 30+ DPD and 90+ DPD

- If lifetime PD at origination not available
  - 12-month PD
  - Credit rating

- Additional indicators (forbearance flag, EWS, watchlist,…)

EY

Staging - backtesting

Outflow view
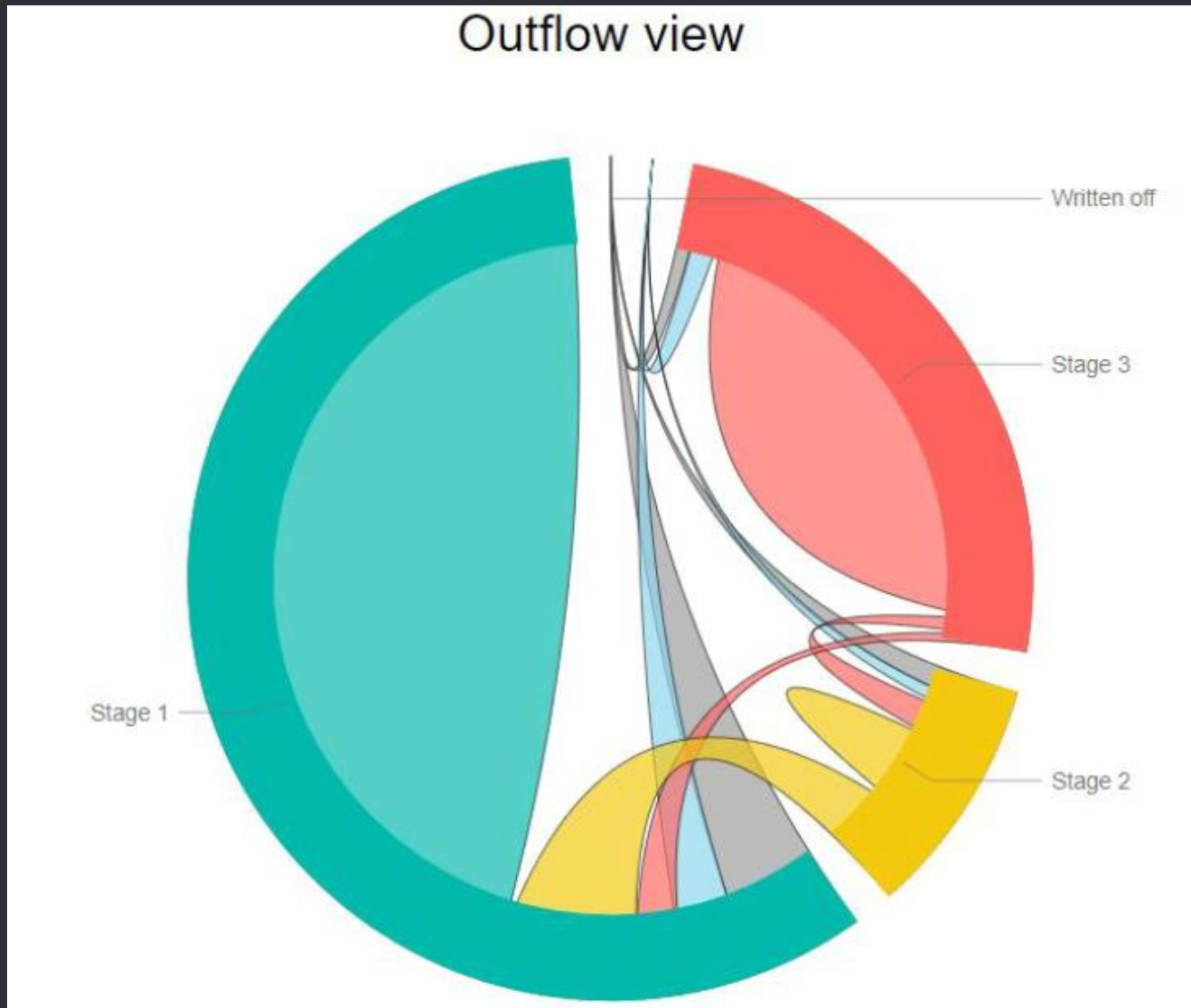
Staging – good practice

- Combining absolute and relative lifetime PD change or different thresholds for different ratings

- Different rating staging rules for different segments (retail/corporate, consumer loans/mortgages)

- Fallback in case origination rating/PD are unavailable – instant stage 2 assignment

- For Czechia – Centrální evidence exekucí

- EBA New Definition of Defaut applied for Stage 3

Staging – COVID adjustments

- Adding behavioral signals

- Sub-portfolio SICR (vulnerable sectors)

- Tightenning certain thresholds

Staging – frequent issues

- Overuse of low risk exemption

- EBA new definition of default not implemented properly (probation period, LIFO)

- Forbearance not properly identified

- Too tight SICR criteria – overuse of stage 2 with frequent migrations back to stage 1

EY

ECL calculation - introduction

- Collective assessment approach
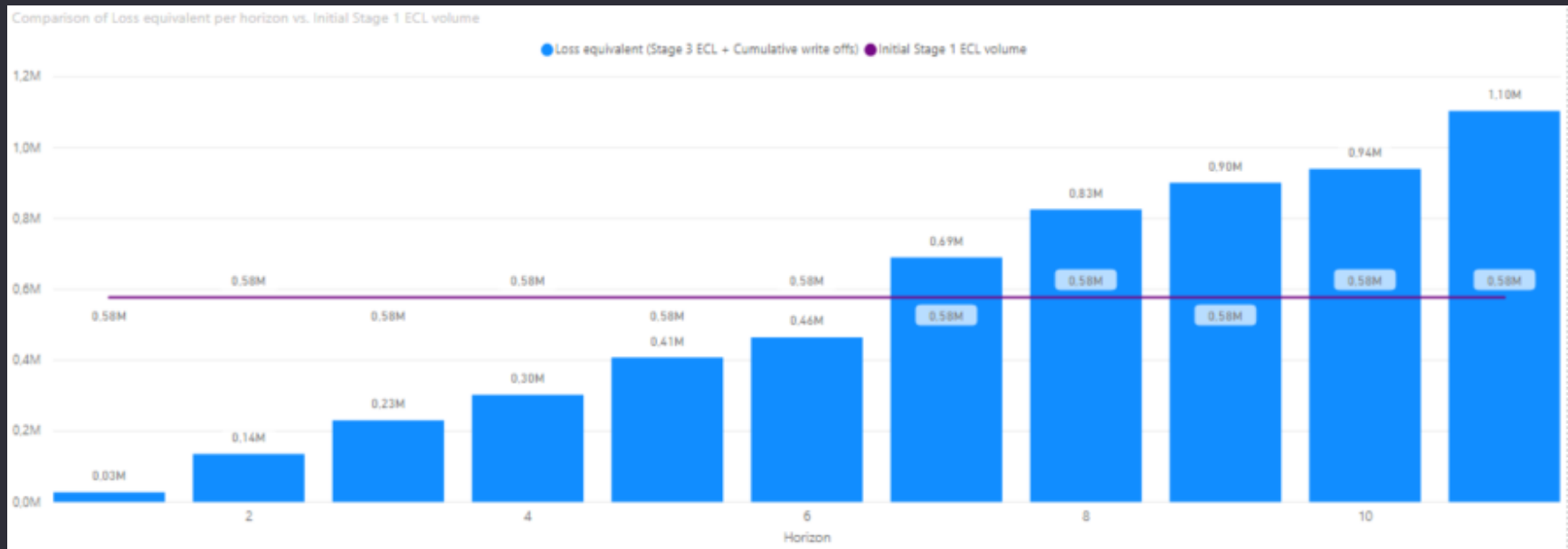 - Statistical credit risk models are applied (PD, LGD, EAD, forward outlook shift)

$$ECL_{S2} = \sum_{t=1}^{M} \frac{EAD_t * PD_t * LGD_t}{(1 + EIR)^t}$$

- Individual assessment approach
  - Used for individually significant clients, particularly, in stage 3
  - ECL calculated using discounted cash flows approach for multiple probability weighted scenarios

$$ECL_{S3} = \sum_{i=1}^{n} p_i * \sum_{t=1}^{l} \frac{CF_{t,i}}{(1 + EIR)^t}$$
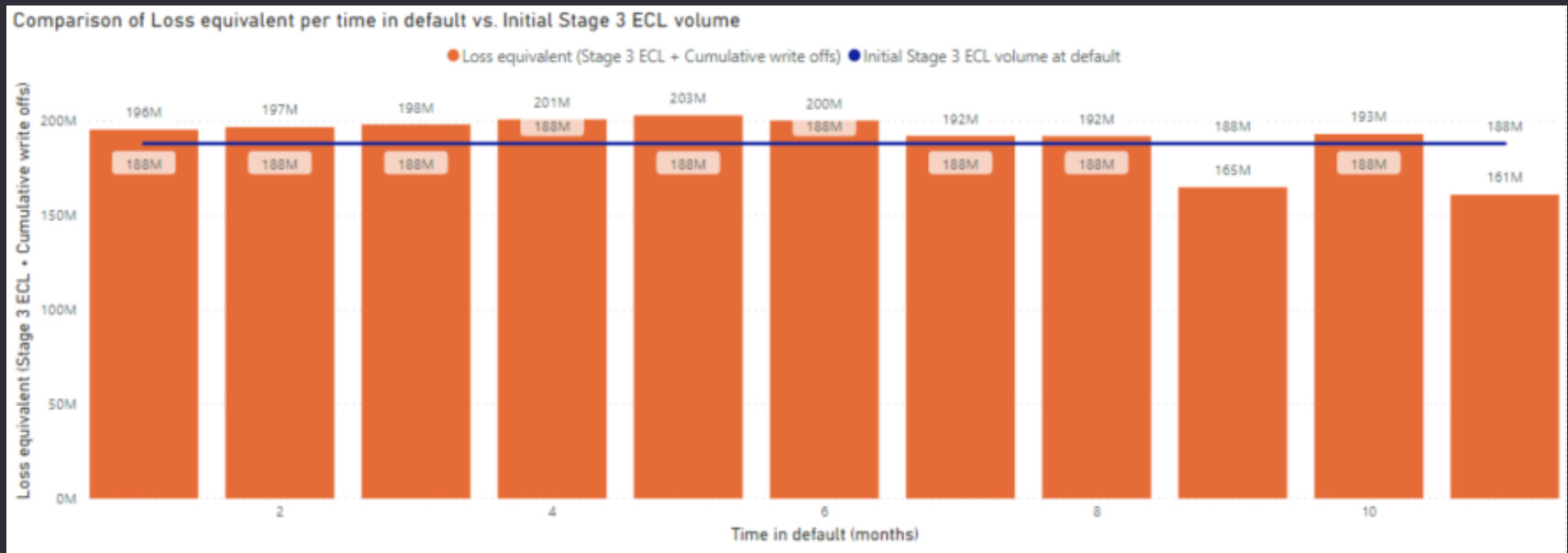
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ECL calculation – backtesting stage 1

- Compare ECL at the beginning of the period with losses incurred for the 12 month period for the same pool of accounts
  - Losses calculated as stage 3 provisions (+ write-offs)

Comparison of Loss equivalent per horizon vs. Initial Stage 1 ECL volume

● Loss equivalent (Stage 3 ECL + Cumulative write offs) ● Initial Stage 1 ECL volume

ECL calculation – backtesting stage 3

- Compare initial stage 3 ECL for a vintage of defaulted accounts with losses in subsequent periods for the same pool of accounts
  - Losses calculated as ECL in any stage + write-offs

Comparison of Loss equivalent per time in default vs. Initial Stage 3 ECL volume

● Loss equivalent (Stage 3 ECL + Cumulative write offs) ● Initial Stage 3 ECL volume at default

	196M	197M	198M	201M	203M	200M	192M	192M	188M	193M	188M

Values shown: 188M, 188M, 188M, 188M (labeled), 188M, 188M (labeled), 188M, 188M, 165M, 188M, 161M

Y-axis: Loss equivalent (Stage 3 ECL + Cumulative write offs) — 0M, 50M, 100M, 150M, 200M

X-axis: Time in default (months) — 2, 4, 6, 8, 10

EY

ECL calculation – good practice

- Individual assessment truly individual with scenarios supported by work-out strategies

- Stage 2 backtesting utilizing lifetime ECL for assets migrated into stage 1

- Replacing COVID overlays by improved models

EY

ECL calculation – COVID adjustments

- Management overlays very extensively applied

- More flexible and automed ECL calculation allowing for frequent simulations

EY

ECL calculation – frequent issues

- Overuse of loss rate approach

- POCI approach ignored

- EIR aproximated by nominal interest

- Backtesting not conducted or, backtesting approach not sound

- 100% provisioning or write-off even for assets with still expected recovery

- Overprovisioning

EY

Forward looking adjustment - introduction

- IFRS 9 requires to reflect future macroeconomic development into ECL

- Multiple macroeconomic scenarios with their probability weights should be considered

- Regression models callibraing macroeconomic impacts on risk parameters are typically very simple
  - Unemployment driven retail risk parameters
  - GDP driven corporate risk parameters

EY

Forward looking adjustment - backtesting

- Macro scenarios and their weights generally not backtested (yet)

- Regression models calibrating macroeconomic impacts on individual risk parameters shoud be backtested

EY

Forward looking adjustment – good practice

- Scenarios aligned with forecasts of reputable institutions

- Scenarios aligned with business strategy and stress testing

- Scenario weights supported by distribution of forecats

- Suplementary risk parameters like CCF and prepayments also tested for dependence on macro

EY

Forward looking adjustment – COVID adjustments

- Management overlays

- Increased number of future macroeconomic scenarios in response to high uncertainty

- More flexible and automed ECL calculation allowing for frequent simulations

EY

Forward looking adjustment – frequent issues

- Optimistic scenario undercalibrated compared to pesimistic scenario (probability weighted scenario always more pesimistic than base scenario)

- Scenario weights arbitrary

- Forecasts on unreliably long future

- Macroeconomic impact on risk parameters not supported by predictive power of regression model

- Only PD adjusted, not LGD

EY

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Q&A?

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The better the world works.

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