EUROPEAN CENTRAL BANK

BANKING SUPERVISION

ECB-PUBLIC

Andrea ENRIA
Chair of the Supervisory Board

To all Significant Institutions

SSM-2020-0154
01 April 2020

IFRS 9 in the context of the coronavirus (COVID-19) pandemic

Dear Sir or Madam,

The ECB is closely monitoring developments related to the COVID-19 outbreak and the risks that such a shock could pose to the safety and soundness of the Significant Institutions and to their continued capability to finance the real economy.

In order to mitigate volatility in institutions' regulatory capital and financial statements stemming from IFRS 9 accounting practices in the current context of extraordinary uncertainty, on 20 March 2020 (see the ECB press release: *ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus)*, we recommended that institutions: i) opt to apply the transitional IFRS 9 provisions foreseen in the CRR; and ii) avoid excessively procyclical assumptions in their IFRS 9 models to determine their provisions. Furthermore, we indicated that we would provide significant institutions with central macroeconomic scenarios to be used for IFRS 9 modelling purposes.

In respect of the application of the CRR's transitional IFRS 9 provisions, we would like to further add that also those institutions that have so far only applied the static component are highly encouraged to apply the full transitional arrangements.

The purpose of this letter is to provide significant institutions with further guidance on and references to the use of forecasts to avoid excessively procyclical assumptions in their expected credit loss (ECL) estimations during the COVID-19 pandemic. In particular, the guidance in the annex covers: i) the collective assessment of the significant increase in credit risk (SICR); ii) the use of long-term macroeconomic forecasts; and iii) the use of macroeconomic forecasts for specific years.

While each significant institution should make its own assumptions and take its own decisions on the level of provisions required in line with IFRS 9, we expect significant institutions to consider this guidance when estimating the ECL given the current context of heightened uncertainty and very limited availability of reasonable and supportable forward-looking information on the impact of COVID-19. In particular, we expect institutions to already benefit from this guidance in the course of the next few weeks, as they finalise their year-end note disclosures and prepare their interim reporting, based on IFRS, for the first quarter of 2020.

Given that modelling assumptions and methodologies that prevail in normal times may prove impaired in the current context of extraordinary uncertainty, it appears of paramount importance that significant institutions pay particular attention to the governance of model updates, adjustments and overlays that will prove necessary going forward.

Reducing inappropriate volatility in regulatory capital and financial statements at this juncture is crucial for avoiding procyclical tightening effects on bank lending and for ensuring that, in spite of the uncertainty, institutions' disclosures remain reliable, consistent and comparable.

This overall guidance is consistent with the statements recently issued by other European authorities and international bodies on the use of IFRS 9 in the context of the COVID-19 outbreak, including the European Banking Authority (EBA)[1], the European Securities Markets Authority (ESMA)[2] and the International Accounting Standards Board (IASB)[3]. The ECB welcomes the initiatives taken by those authorities and bodies and encourages all significant institutions to follow their guidance. Those initiatives provide clarity on the room for appropriate judgement embedded in the IFRS 9 standard and guide institutions as to the way relief measures such as payment moratoriums, guarantees and other debtor support initiatives should be factored in when assessing the SICR, and estimating the ECL.

Please be reassured that we intend to continue monitoring developments related to the COVID-19 outbreak and may take additional measures and/or provide additional guidance to the significant institutions, including in the area of IFRS accounting, should this become necessary to safeguard the soundness and the robustness of their disclosures. Again, we shall do so in coordination with other European authorities and international bodies.

Yours sincerely,

[signed]

Andrea Enria

1 https://eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures
2 https://www.esma.europa.eu/document/esma-statement-markets-and-covid-19
3 https://www.ifrs.org/news-and-events/2020/03/application-of-ifrs-9-in-the-light-of-the-coronavirus-uncertainty/

Guidance on the use of forecasts to estimate the ECL during the COVID-19 pandemic

It is clear that the COVID-19 outbreak is likely to result in a significant and swift decline in economic activity across the euro area and globally. Financial markets have responded to the shock with pronounced volatility and both authorities and analysts are revising macroeconomic forecasts downwards to reflect the increasing severity of the social restrictions imposed to contain the pandemic. At the same time, governments and central banks – across the euro area and beyond – are taking wide-reaching action to support businesses and households throughout the turmoil. In this context, a sharp rebound in economic activity could be expected once the social restrictions have been lifted.

The IFRS 9 standard requires institutions to estimate the ECL by taking into account *"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"* (see IFRS 9, paragraph 5.5.17 (c)). The ECB is aware that the current context of pronounced uncertainty leaves significant institutions with very little reasonable and supportable forward-looking information, making the task of producing long-term detailed forecasts extremely challenging.

Within our remit as a prudential supervisory authority, and fully in line with the letter and spirit of international accounting standards, here are further detailed considerations that we expect significant institutions to take into account when using forecasts to estimate the ECL.

1) <u>Collective assessment of the SICR</u>

ECL estimates are very sensitive to macroeconomic forecasts. Evidence available to the ECB shows that a deterioration in the GDP outlook could lead to a manifold increase in the probability of default (PD). The latter, determines, among other indicators, the transfer of the financial instrument from Stage 1 to Stage 2. In particular, the way short-term GDP forecasts are extrapolated along the banking books' remaining maturity may have a higher impact on loan loss provisions than the short-term macroeconomic impact itself. Extrapolations beyond the short-term horizon are also the most uncertain; especially now as even short term outlooks have become quite uncertain.

When applying macroeconomic forecasts and other information that are only available at the collective level,[4] the resulting increase in the PD might indicate that portfolios assessed collectively have suffered a SICR as a whole even if this increase will, most likely, not affect all clients equally.

Against this backdrop, significant institutions are expected to:

- consider whether a top-down approach to stage transfers can be taken (see IFRS 9, paragraph B5.5.6 and IE39), and;

4 This is particularly relevant under the current circumstances. In addition to factors usually assessed collectively (e.g. economic outlooks, employment status of retail clients with respect to certain industries or employers), now even factors usually assessed individually have become very sensitive to macroeconomic scenarios.

- in the context of that approach, recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly without the need to identify which individual financial instruments have suffered a SICR.

2) Use of long-term macroeconomic forecasts

IFRS 9 recognises that information relevance decreases as the forecast horizon increases[5] and emphasises the relevance of historical information[6]. In this regard, the IFRS 9 provisions lead to the conclusion that where there is no reliable evidence for specific forecasts, long-term macroeconomic outlooks will provide the most relevant basis for estimation.[7]

Since the ECB does not regularly publish long-term macroeconomic forecasts, significant institutions are encouraged to use their own macroeconomic research and reliable external sources.

In this regard, significant institutions are expected to:

- use available historical information, but only as far as this information is representative for the long-term horizon and free of bias;
- where historical information depends on macroeconomic variables, consider information covering at least one or more full economic cycles or that is otherwise adjusted to avoid biases, e.g. a recency bias.

3) Use of macroeconomic forecasts for specific years

The Eurosystem/ECB staff publishes macroeconomic projections four times a year, which extend at least over a three-year horizon.

The latest ECB publication on macroeconomic projections dates back to 12 March 2020 and includes information as of end-February 2020.[8] As explained by the ECB, even if the latest ECB publication points to a deteriorating economic outlook on account of the COVID-19 outbreak, the March 2020 projections do not incorporate the impact of the lockdowns and severe social distancing restrictions imposed across countries in March 2020, nor do they take into account the unprecedented public support measures announced and implemented by several Member States in that period.

---

5 "The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future — for such periods, an entity may extrapolate projections from available, detailed information." (see IFRS 9, paragraph B5.5.50).

6 "Historical information is an important anchor or base from which to measure expected credit losses. […] In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered […]" (see IFRS 9, paragraph B5.5.52).

7 This principle can also be found in the accounting standards developed by the FASB (see the FASB Accounting Standards, Codification 326-20-30-9).

8 https://www.ecb.europa.eu/pub/projections/html/ecb.projections202003_ecbstaff~dfa19e18c4.en.html#toc6 and for quarterly data https://www.ecb.europa.eu/pub/projections/html/index.en.html

When using specific period forecasts for estimates as of the first quarter of 2020, we consider that significant institutions should:

- use the March 2020 ECB staff macroeconomic projections for the euro area as anchor points;
- exercise an informed judgement to update those projections to reflect both the lockdowns and the severe social distancing restrictions imposed on the various economies as well as the substantive public support measures announced and implemented across countries;
- exercise an informed judgement about a potential rebound of the economy to the long-term trend, taking into account that the ECB would not object to any judgement that this rebound might occur within 2020 given the current level of uncertainty.

The next ECB publication regarding the euro area outlook, which is based on country-specific projections by the national central banks, is planned for 4 June 2020. The ECB expects the significant institutions to take into account these future publications accordingly for their quarterly accounts prepared as of 30 June 2020.

To include forward-looking information in ECL models, it is quite a common practice among significant institutions to establish a baseline macroeconomic scenario. In doing so, we consider that banks should:

- consider macroeconomic forecasts for specific years and long-term forecasts, as previously described;
- factor these two types of forecasts into the baseline scenario with weights based on their respective relevance;
- assign more weight to the specific-period macroeconomic forecast for the short-term outlook and systematically reduce that weight as the forecast loses relevance for time horizons in the more distant future;
- use the long-term forecast (e.g. the long-term GDP growth rate) whenever the specific forecast has lost relevance.

Given that published ECB staff macroeconomic projections for the euro area only cover the current and the next two calendar years, and also that the published ranges of uncertainty expand considerably along these years, the ECB is of the opinion that, irrespective of the current crisis, institutions should only use the long-term forecasts beyond the horizon of those projections. As mentioned, institutions are to assess whether they need to revert to the long-term forecasts even faster. Given the high levels of uncertainty that characterise the current environment, the ECB would not object to a bank's conclusion that mean reversion can be assumed earlier than under normal conditions.[9]

9 For clarity, with regard to GDP, mean reversion is understood as a return to long-term growth rates (reverting to the absolute levels of GDP that were expected previously for the future would require above-the-mean growth rates).

Institutions that use other scenarios in addition to the baseline scenario are expected to:

- estimate the probabilities of these scenarios and their deviation from the baseline according to the above principles;
- ensure that the probabilities assigned to scenarios and the deviations of such scenarios beyond the reliable forecasting horizon reflect experience collected over a sufficiently long-term horizon and not be based on specific year projections.