IFRS 9 expected credit loss (ECL), a benchmark of 2021 impacts and perspectives on climate risk

EY webcast

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Building a better working world

IFRS 9 ECL benchmark

Laure Guégan

IFRS 9 ECL benchmark
Year-end 2021

2021 key trends

- Improvement of macroeconomic outlook
- Risk indicators are still benign, but uncertainties remain
- Banks can be grouped in three main trends:
  - Significant ECL net releases driven by significant releases of Stage 1 (S1) and Stage 2 (S2) ECL allowance (following a sharp increase in 2020) and low levels of Stage 3 (S3) losses
  - Close to nil or slightly negative ECL charges, reflecting an offsetting effect between releases of S1 and S2 allowance and low S3 losses
  - More normalized levels of ECL charges (close to 2019 or slightly lower), with S1 and S2 allowance kept stable or slightly increased – this is the case for most of the other banks
- Overlays maintained compared to year-end 2020 (but generally reduced compared to half year 2021)
- 2022 outlooks released in early February generally referred to a normalization of the Cost of Risk (CoR), around through-the-cycle levels or below pre-COVID levels

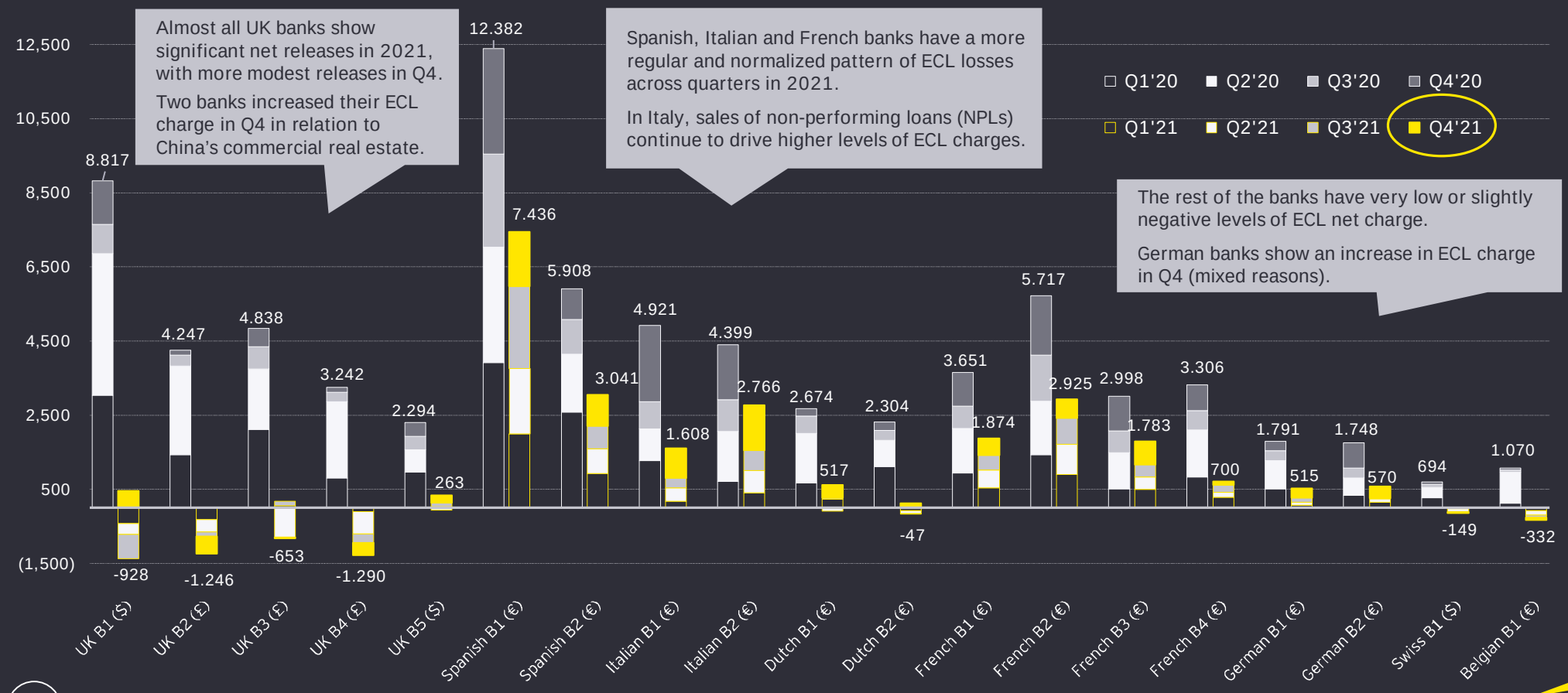
Analysis based on earnings communication of 19 large European banks (IFRS financial statements and earnings releases)

Areas of focus: ECL profit/loss (P/L) charge, net additions to S1 and S2 since the beginning of the crisis, overlays, coverage ratios, macroeconomic sensitivities

US banks impairment results are also presented in the appendix

Q4 2021 was another benign quarter, confirming the 2021 trend, with overall low ECL expenses and significant releases in the UK

ECL P/L charge (in millions; in reporting currency)



The average CoR has dropped to 15bps, after a spike at 81bps in 2020, but the average hides very different trends across countries

CoR = total ECL P/L charge/gross loans to customers at reporting date (in bps)

After a sharp spike in 2020 (95bps on average representing 3x times the 2019 CoR), almost all UK banks are showing a negative CoR in 2021.

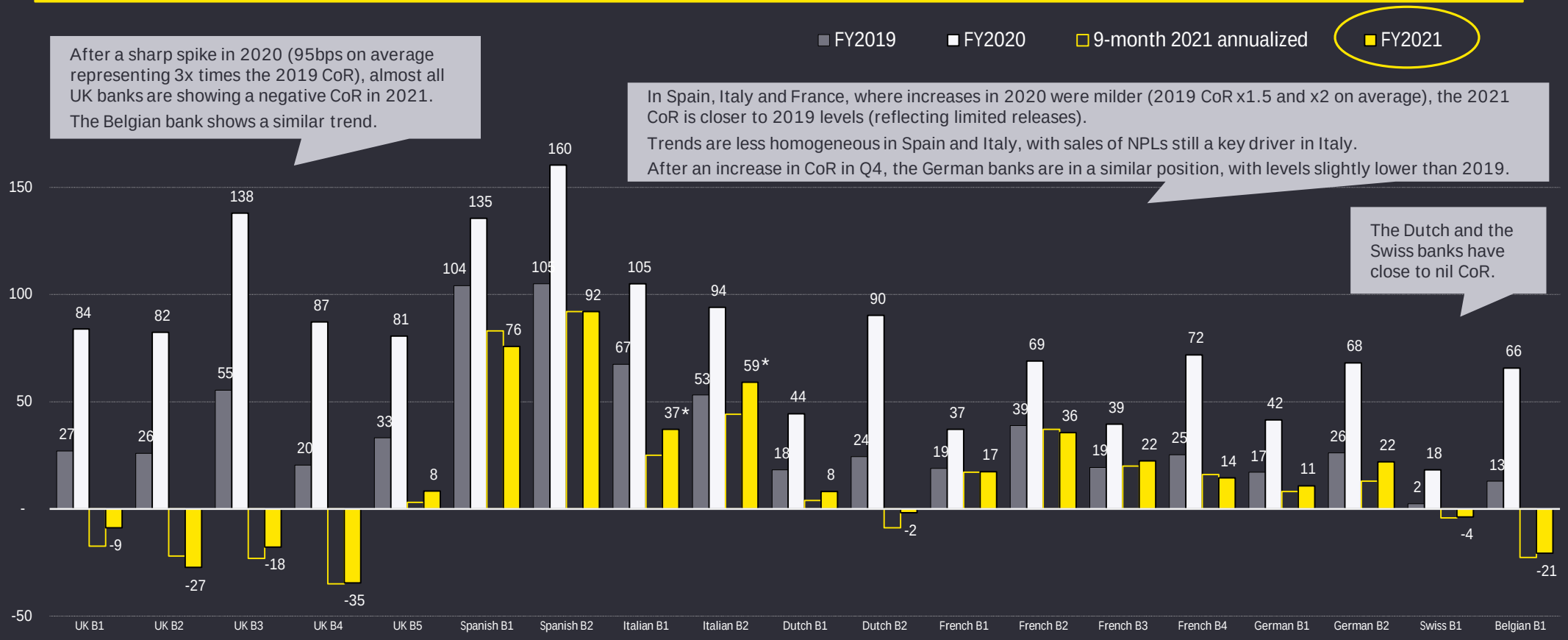
The Belgian bank shows a similar trend.

In Spain, Italy and France, where increases in 2020 were milder (2019 CoR x1.5 and x2 on average), the 2021 CoR is closer to 2019 levels (reflecting limited releases).

Trends are less homogeneous in Spain and Italy, with sales of NPLs still a key driver in Italy.

After an increase in CoR in Q4, the German banks are in a similar position, with levels slightly lower than 2019.

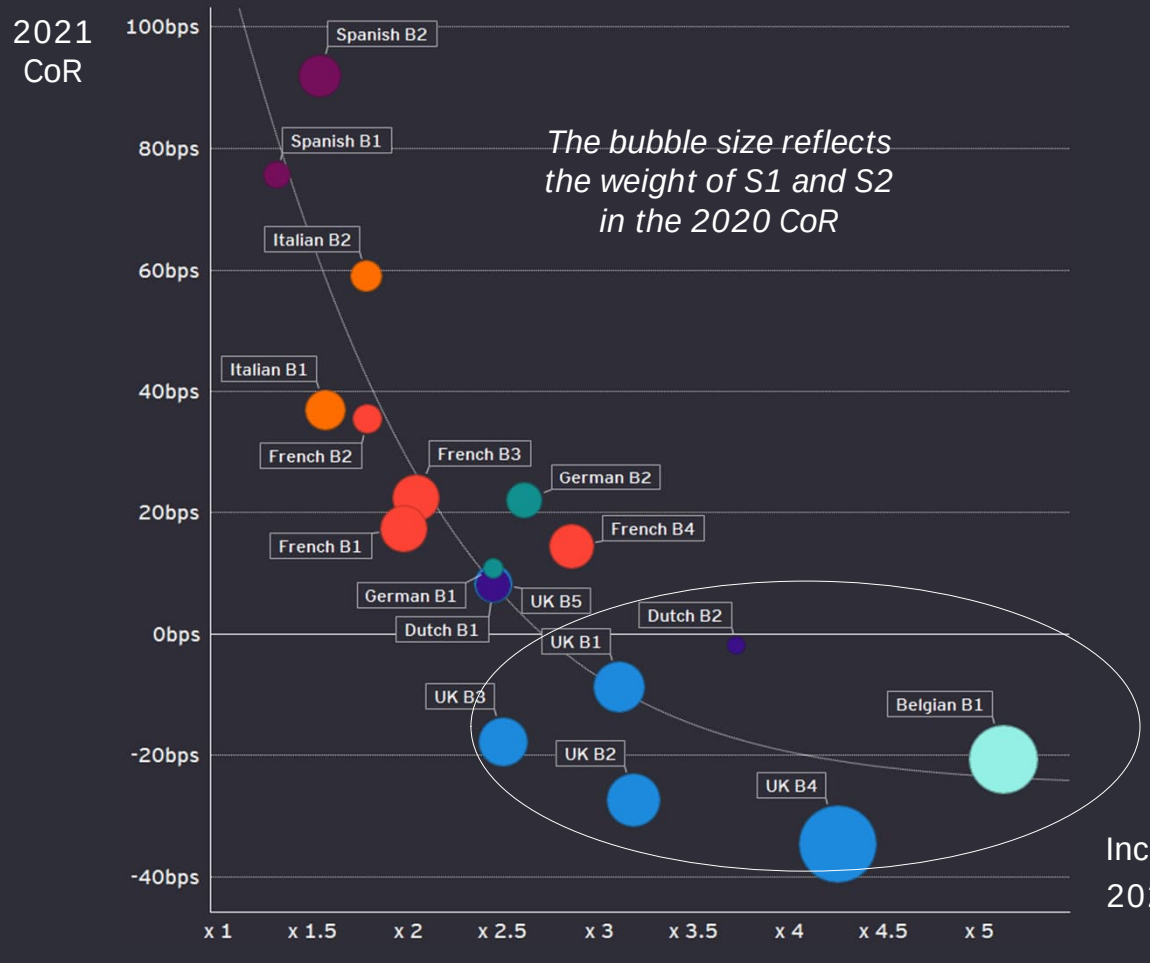
The Dutch and the Swiss banks have close to nil CoR.



* disclosed ratios used at year-end 2021 for these banks, which may slightly differ from the re-calculated ratios used in prior quarters

The level of 2021 CoR seems very much driven by the level of increase in 2020

Correlation between 2021 CoR and the level of increase in 2020 (based on 2020 as a multiple of 2019 CoR)

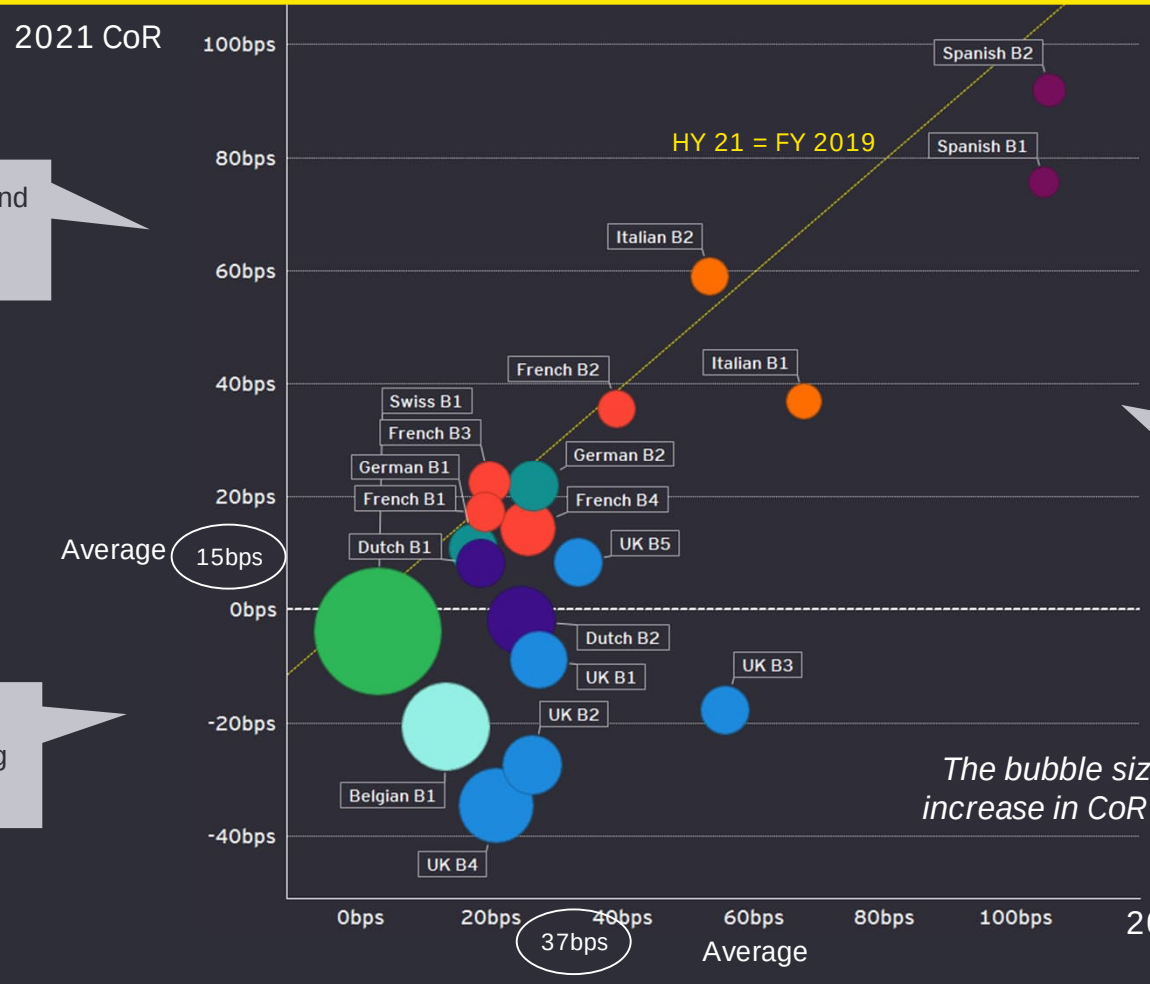


Banks with the highest levels of increase in CoR in 2020 tend to have the lowest levels of CoR in 2021

Increase in CoR in 2020
2020 CoR / 2019 CoR

Comparing 2021 and 2019 reveals that most banks have a CoR in 2021 below the 2019 level

CoR ratio = 2021 ECL compared to 2019 (in bps)



France, Germany, Spain and Italy tend to be closer to 2019 levels

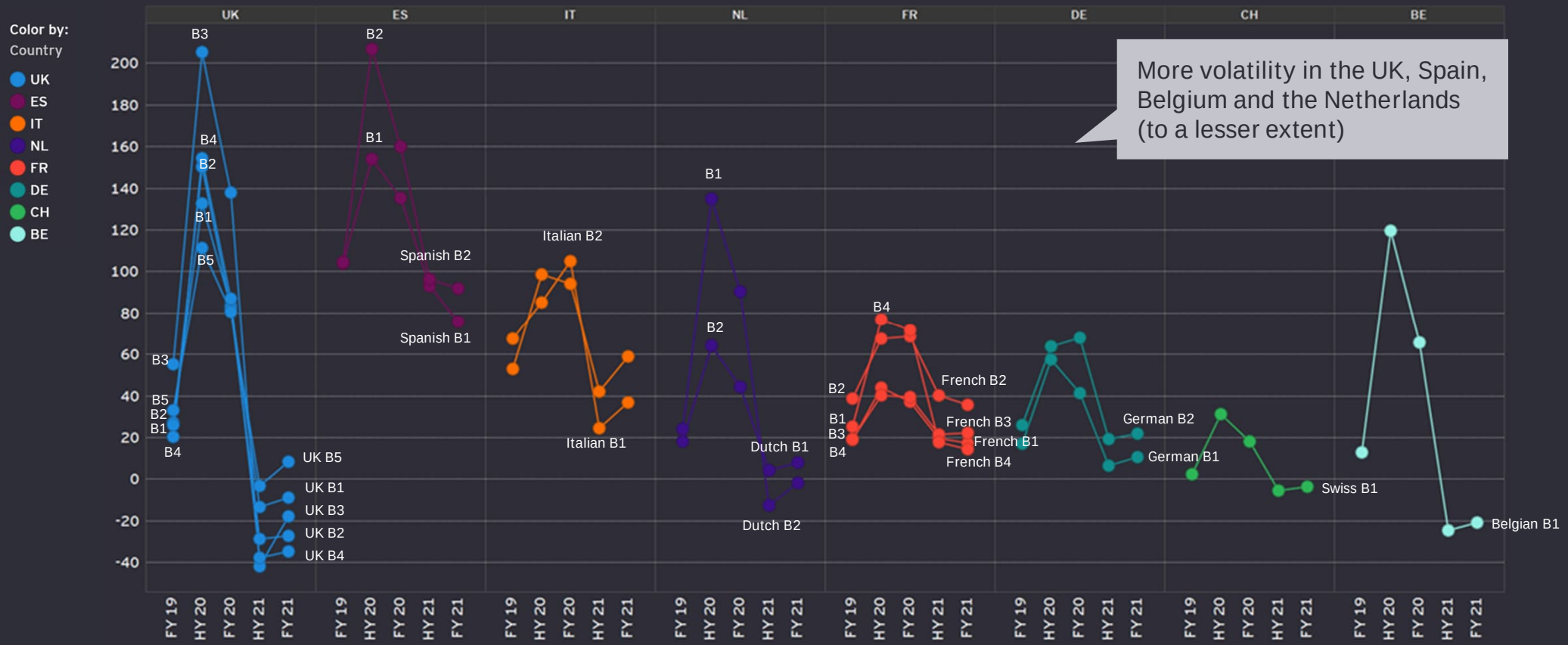
Compared to half-year, banks have generally increased their CoR and moved closer to 2019 levels

Eight banks show a net release in 2021, including all UK banks

The bubble size reflects the level of increase in CoR in 2020 (2020/2019)

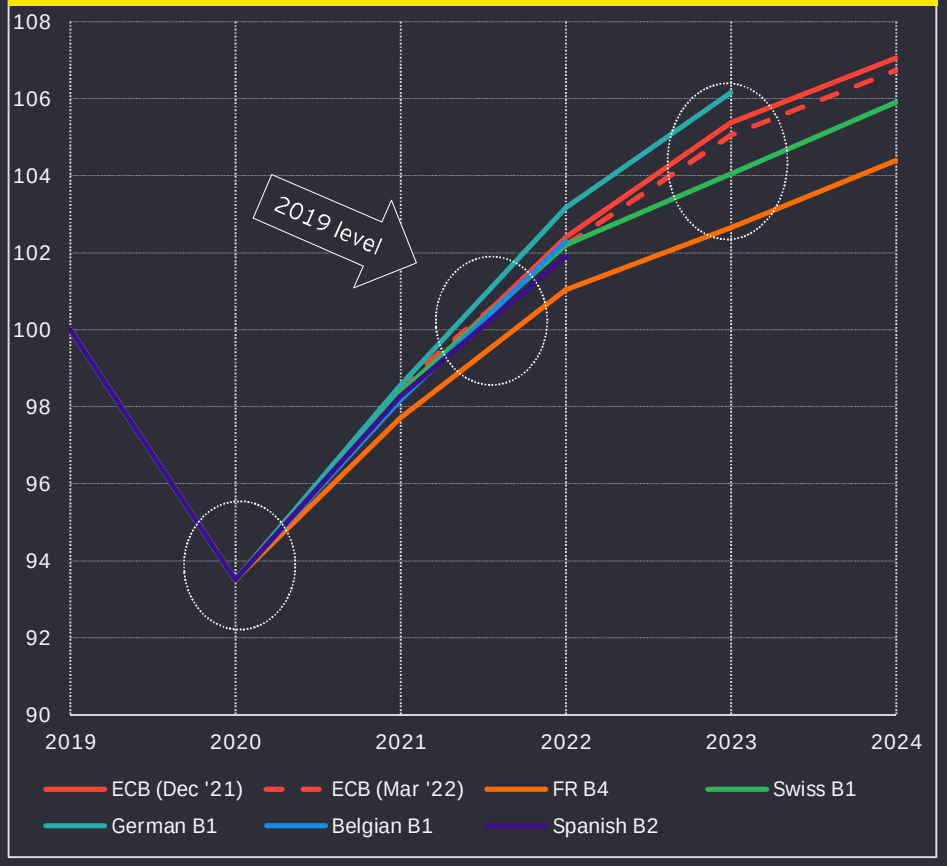
A more detailed view of CoR quarter on quarter confirms contrasted paths across countries, with varying levels of volatility

CoR = total ECL P/L charge/gross loans to customers at reporting date (in bps)

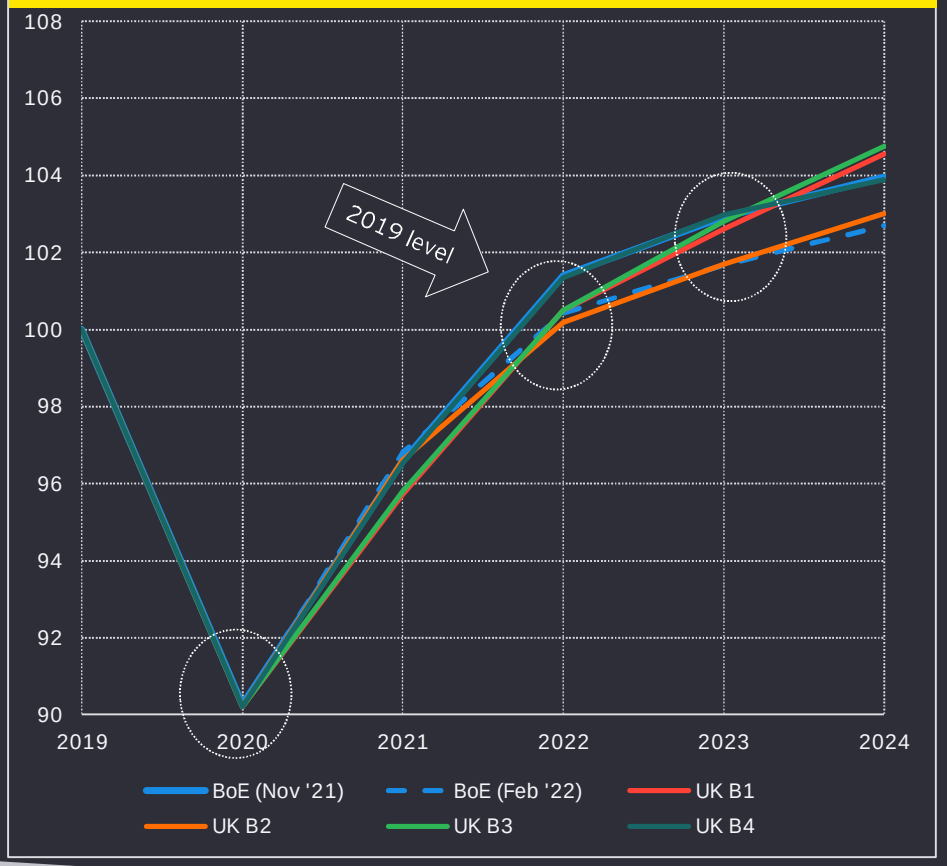


Differences in baseline forecasts may explain some of the differences, as economies experienced varying degrees and timing of impacts

Eurozone GDP baseline forecasts



UK GDP baseline forecasts



- Charts show the GDP forecasts used in FY2021 ECL calculations and the available central bank forecasts at that time
- Also depicted is the most recent available central bank forecasts per mid March

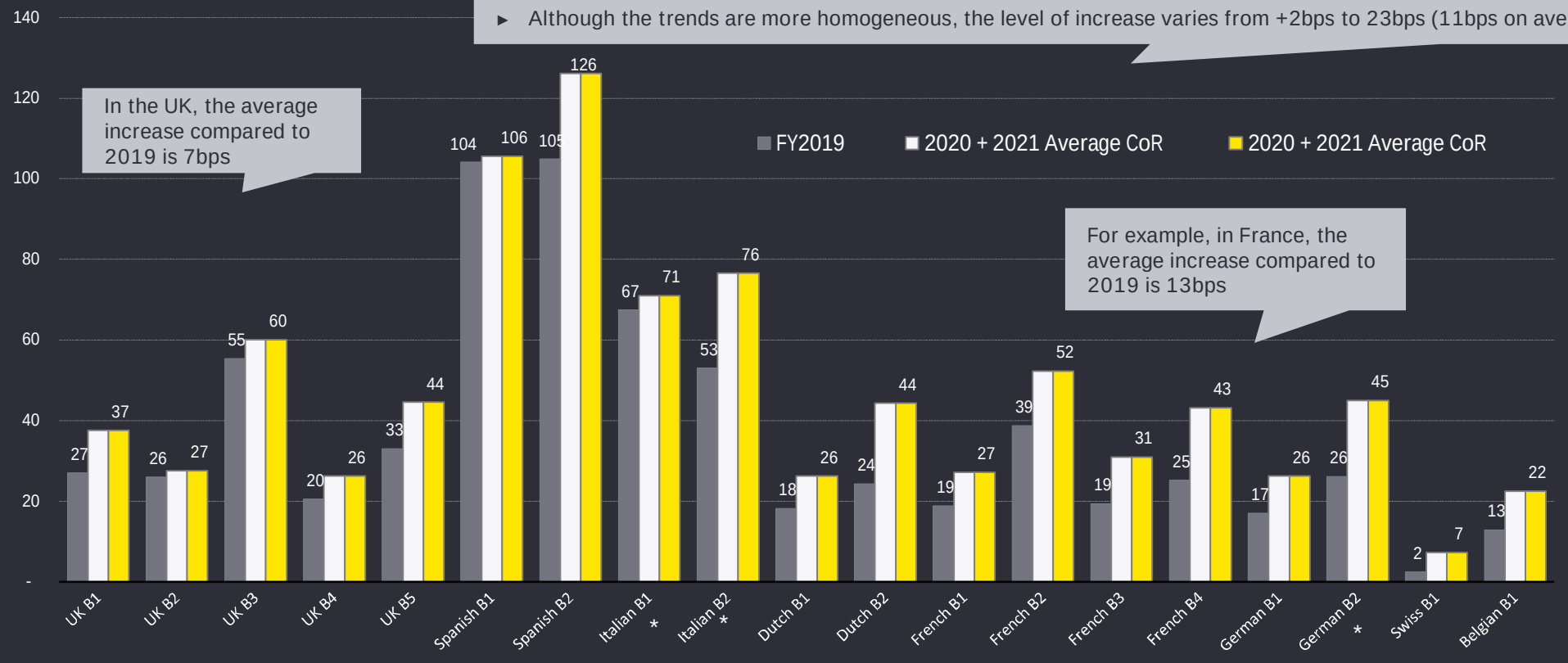
However, averaging the total CoR ratios over 2020 and 2021 gives a more homogeneous picture of the level of increase compared to 2019

CoR = total ECL P/L charge/gross loans to customers at reporting date (in bps)

- The 2020 and 2021 total CoR have been averaged and allocated to both years to remove the volatility effects
- The average CoR in 2020 and 2021 is 47bps compared to 37bps in 2019
- Although the trends are more homogeneous, the level of increase varies from +2bps to 23bps (11bps on average)

In the UK, the average increase compared to 2019 is 7bps

For example, in France, the average increase compared to 2019 is 13bps



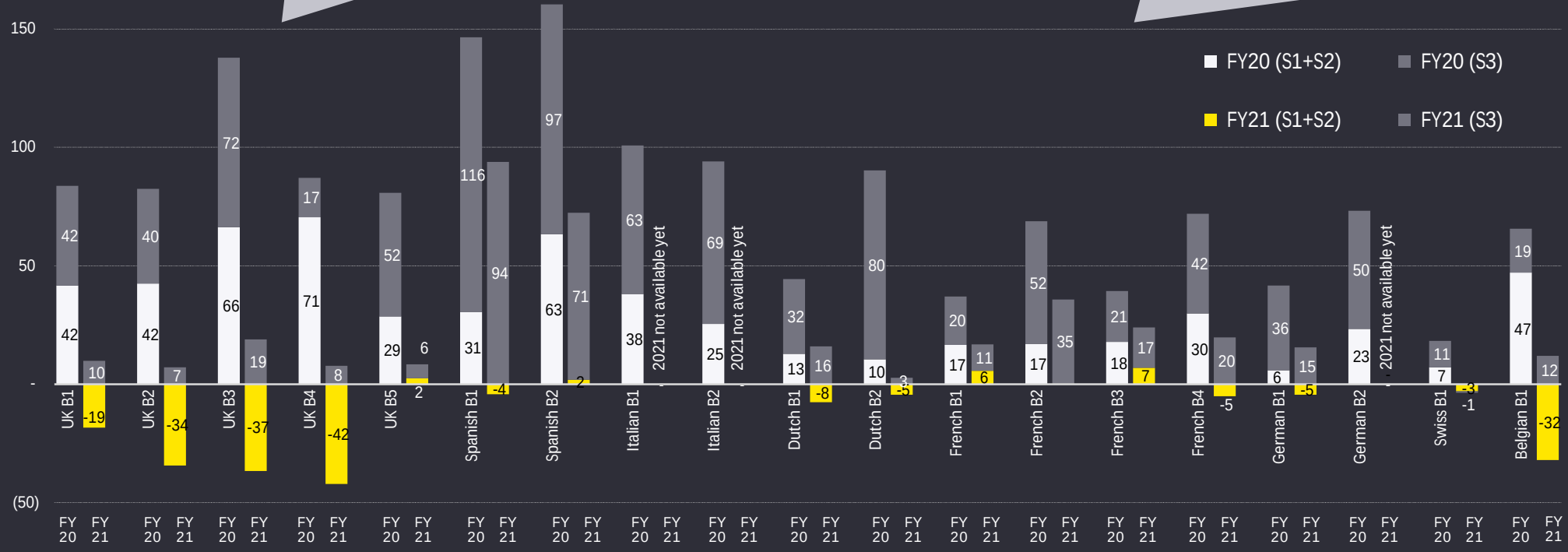
* Disclosed CoR (rather than recalculated) because annual reports not yet available

Differences in CoR paths are driven by S1 and S2, with limited impacts for most banks in 2021, except for UK banks experiencing significant net releases

CoR by stage: 2020 and 2021 split between (S1 + S2) and S3 (in bps)

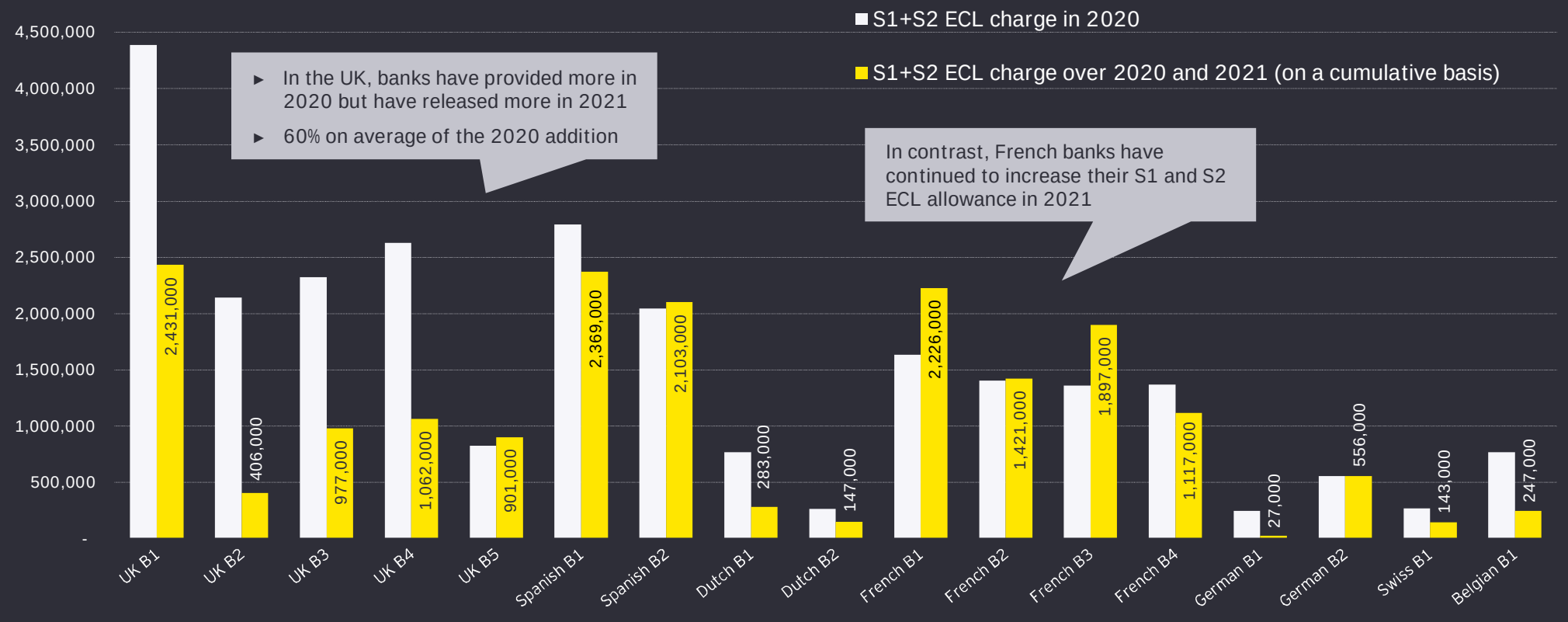
In 2021, the only significant S1 and S2 impacts relate to releases in the UK, as well as in Belgium

- Overall, 2021 impairment charges were driven by S3 losses, with S3 losses still at a historical low (noting that 2020 was also marked by significant single-name losses)
- Limited S1 and S2 releases in other countries



On a cumulative basis, the level of retention of additional stage 1 and 2 ECL allowance varies significantly...

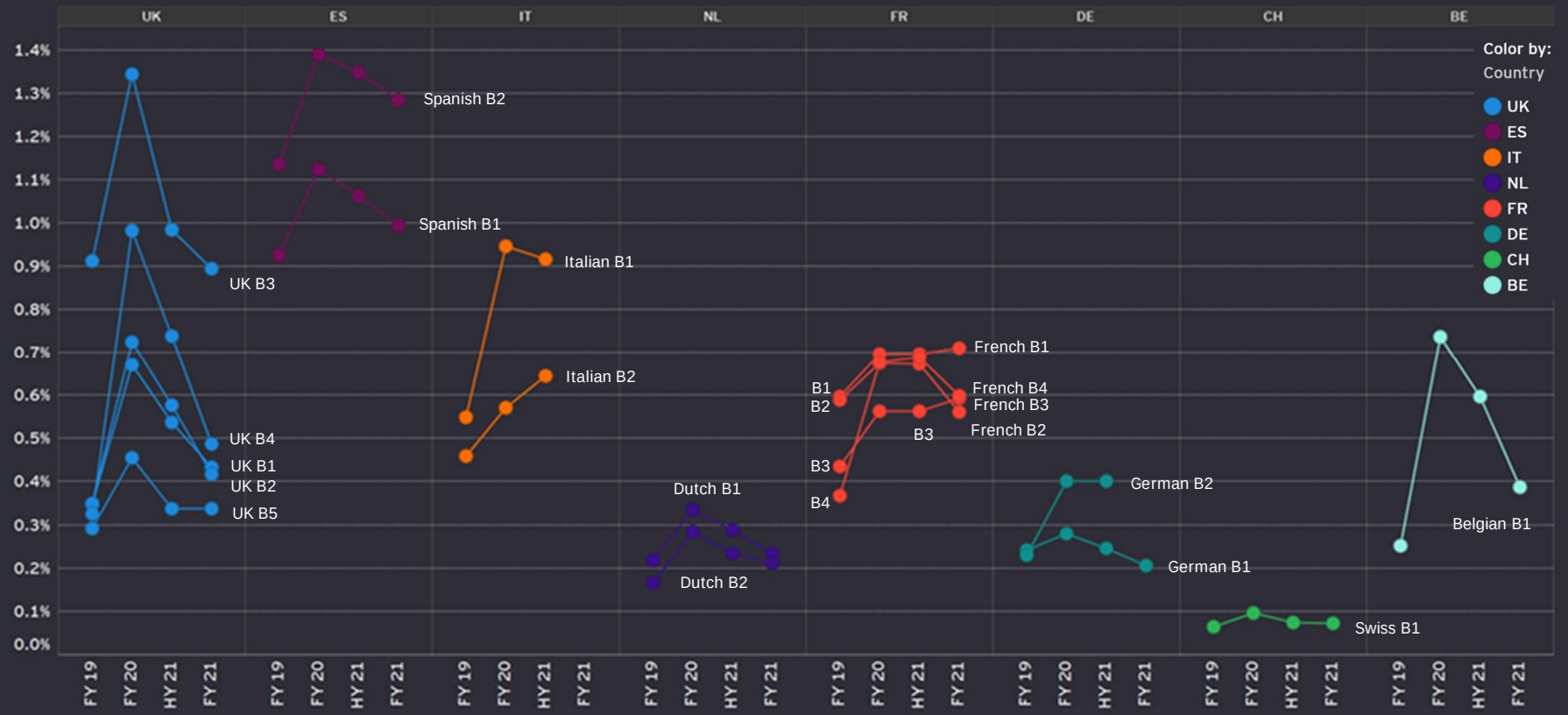
Cumulative net addition to S1 and S2 ECL allowance: FY2020 compared to FY2020 + FY2021 (based on P/L impacts)
[in thousands; in reporting currency]



The banks which have not disclosed the ECL charge specific to S1 + S2 yet are not represented on this graph

… resulting in very different paths in terms of coverage ratios quarter on quarter over the past two years

S1 and S2 coverage ratio (in %): year-end 2019/2020, HY 2021 and year-end 2021 split by country



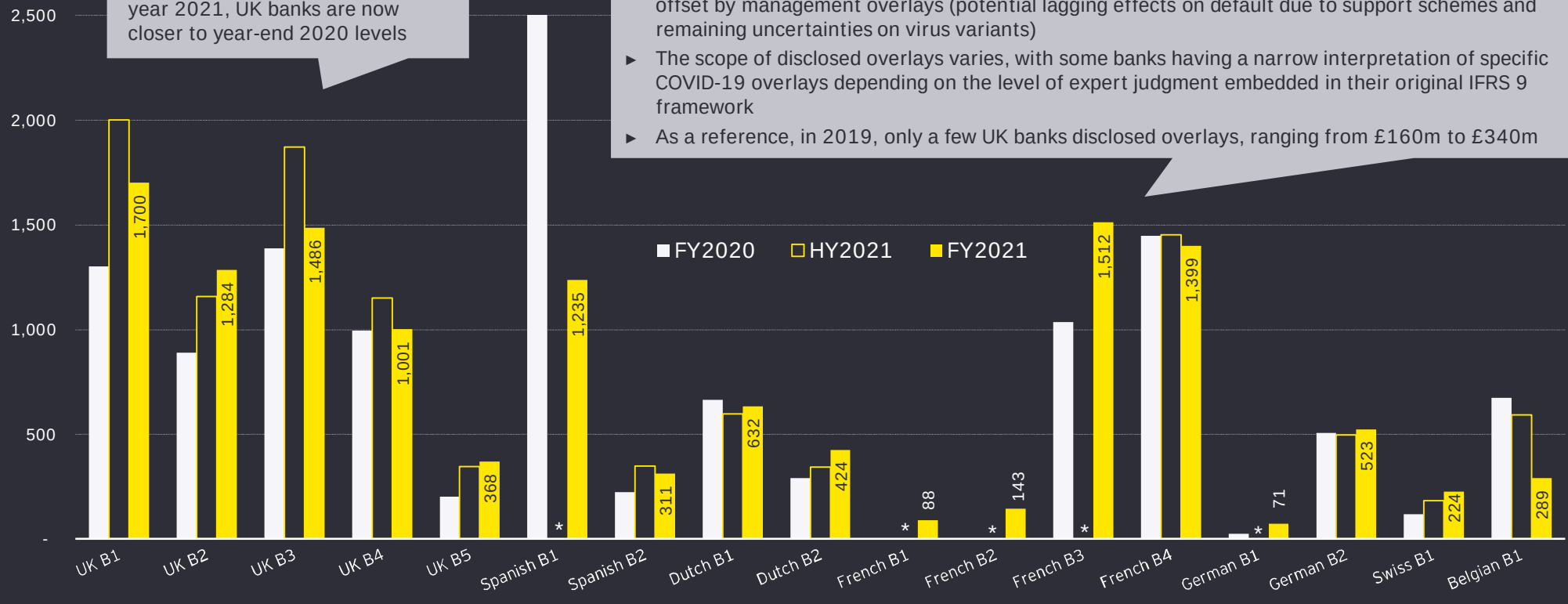
- Six banks are back to their 2019 levels, while 5 banks (generally with lower starting points) have kept a significant increase (above 30%)
- Increased dispersion in Germany and Italy
- Spain, Italy and France have the highest levels but with significant differences in Spain and Italy
- Banks with bigger corporate, small medium enterprises (SME) and consumer portfolios tend to have higher coverage

Significant overlays have been maintained or increased compared to year-end 2020, reflecting remaining uncertainties on possible delayed defaults

Overlays as disclosed by banks (in millions; in reporting currency)

After a spike in overlays at half-year 2021, UK banks are now closer to year-end 2020 levels

- Modeled releases are still not deemed entirely representative of underlying risk and are partly offset by management overlays (potential lagging effects on default due to support schemes and remaining uncertainties on virus variants)
- The scope of disclosed overlays varies, with some banks having a narrow interpretation of specific COVID-19 overlays depending on the level of expert judgment embedded in their original IFRS 9 framework
- As a reference, in 2019, only a few UK banks disclosed overlays, ranging from £160m to £340m



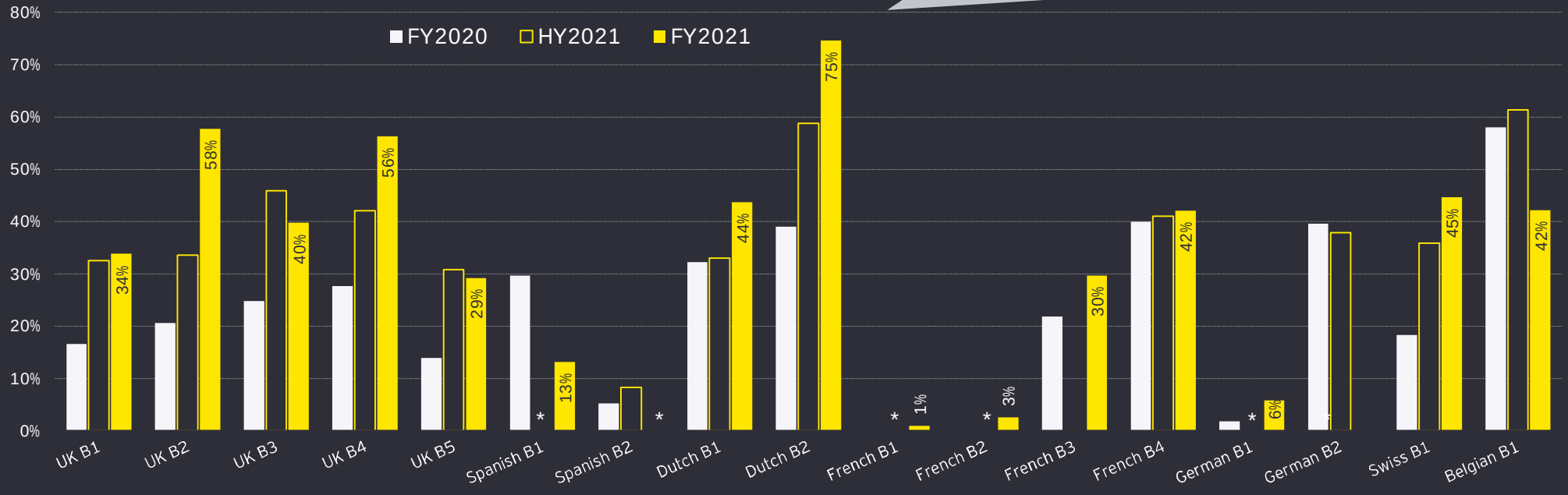
Sample reduced to the banks having disclosed the amount of overlays

* Data not disclosed

The proportion of overlays in S1 and S2 ECL provisions has increased significantly, with levels sometimes as high as 75% of S1 and S2 ECL allowance

Overlays as a % of S1 and S2 ECL allowance (drawn and undrawn exposures)

- Overlays represent 34% of Stage 1 and 2 ECL allowance (on average), compared to 25% at year end 2020
- Increased proportion due to the decrease in Stage 1 and 2 ECL balance with overlays being maintained
- Releases not expected until there is increased visibility around the actual crisis impacts when support measures are withdrawn

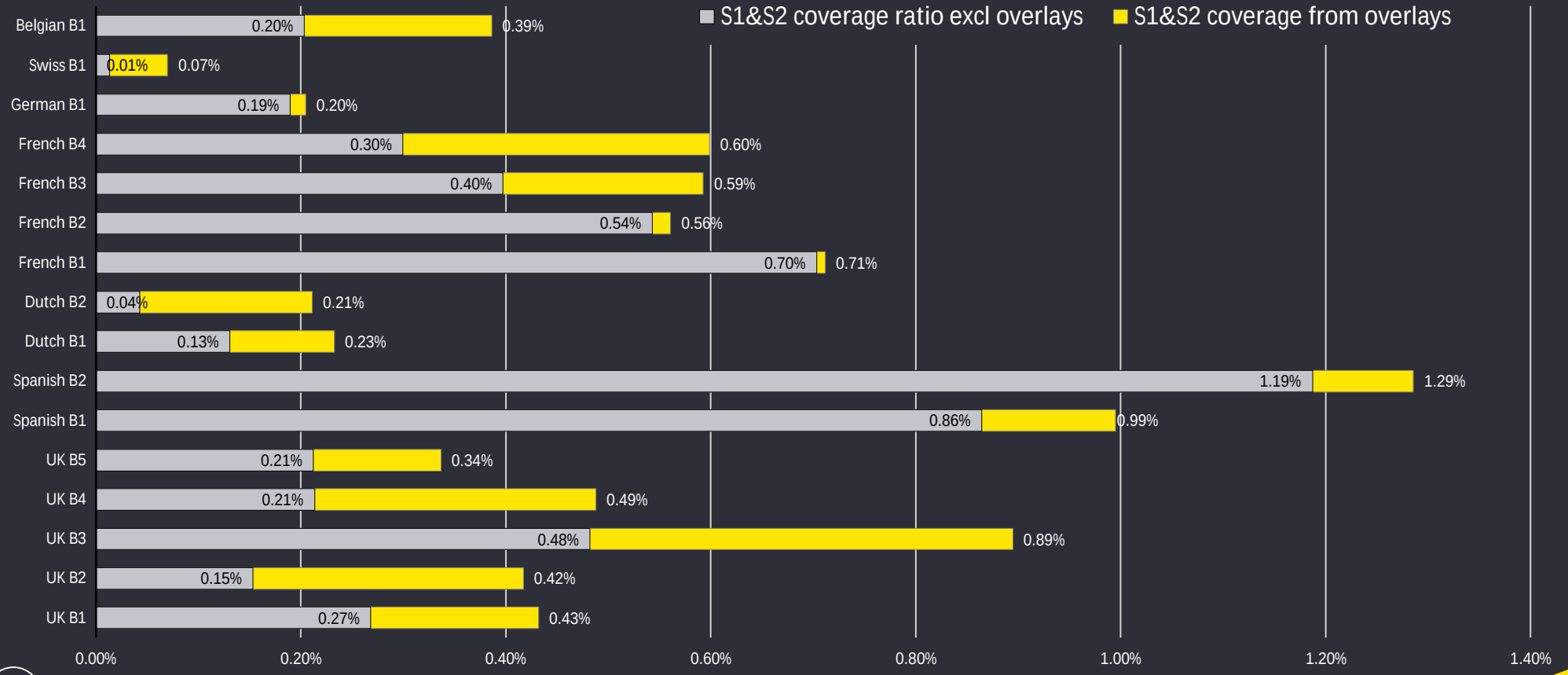


Sample reduced to the banks having already disclosed the amount of overlays and the total ECL allowance for S1 and S2 at the end of FY 2021

* Data not disclosed

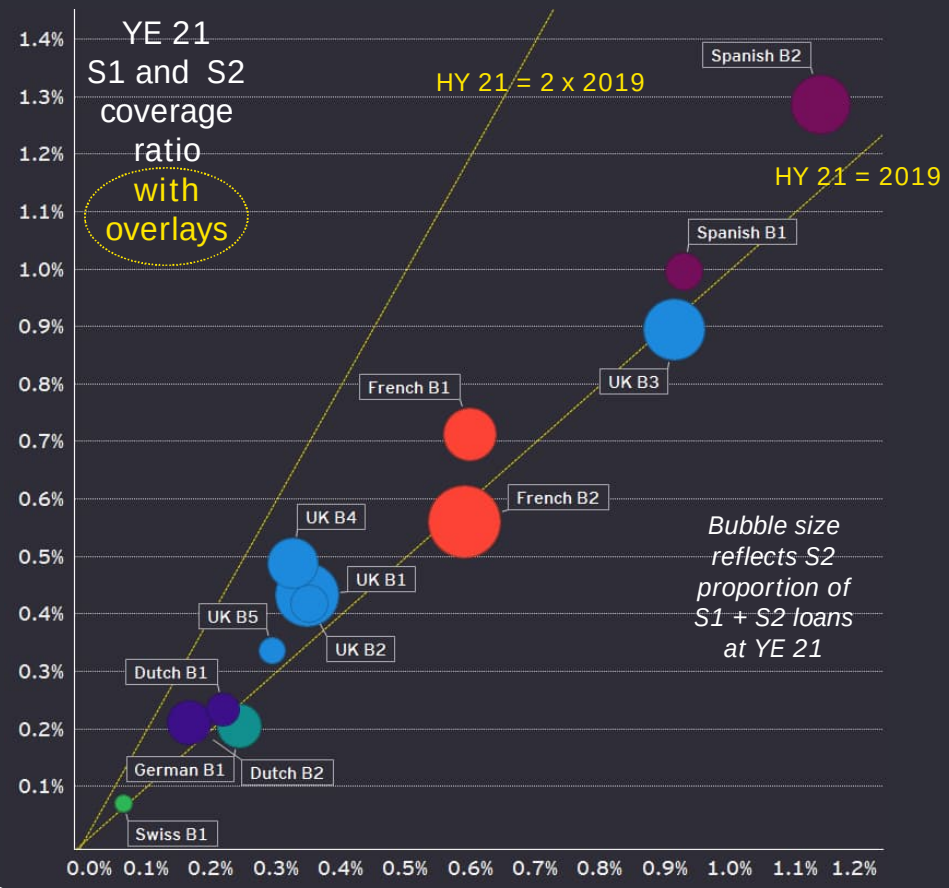
This means that the impact of overlays on coverage ratios (S1 & S2) is very significant for a number of banks

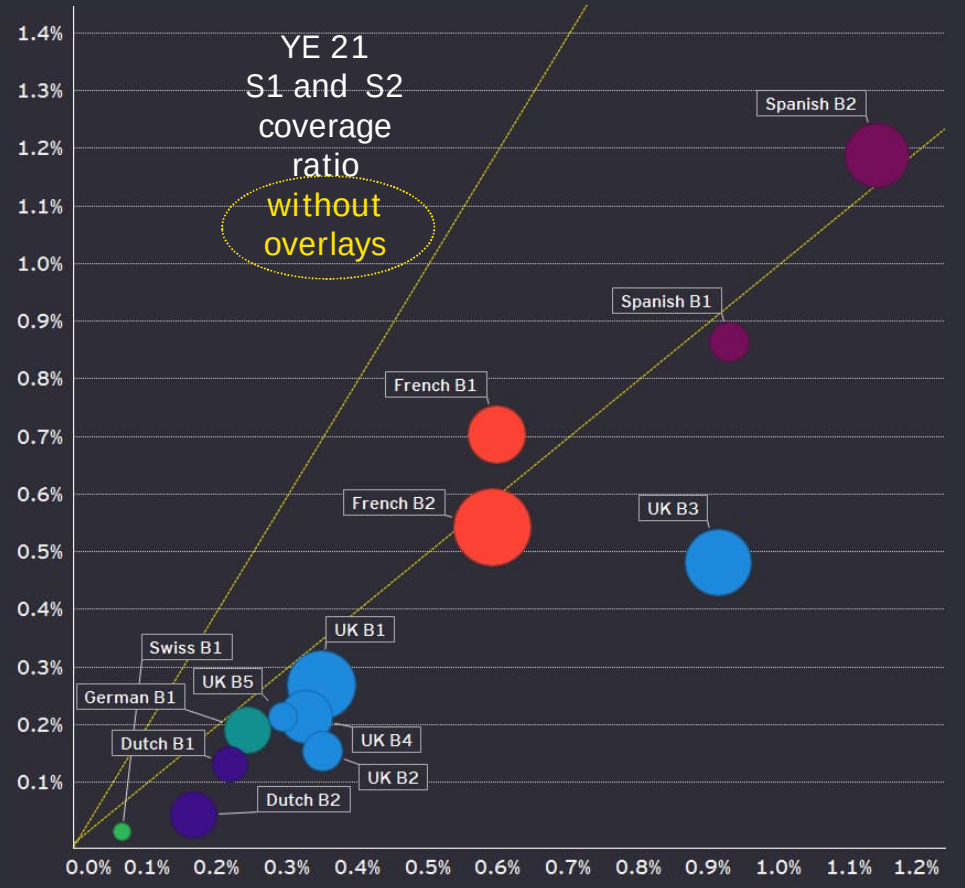
S1 and S2 coverage ratio (in %): total ratio versus ratio excluding overlays



The increase in coverage ratios (compared to 2019 levels) is mainly attributable to overlays

S1 and S2 coverage ratio (in %): FY 21 compared to FY 2019

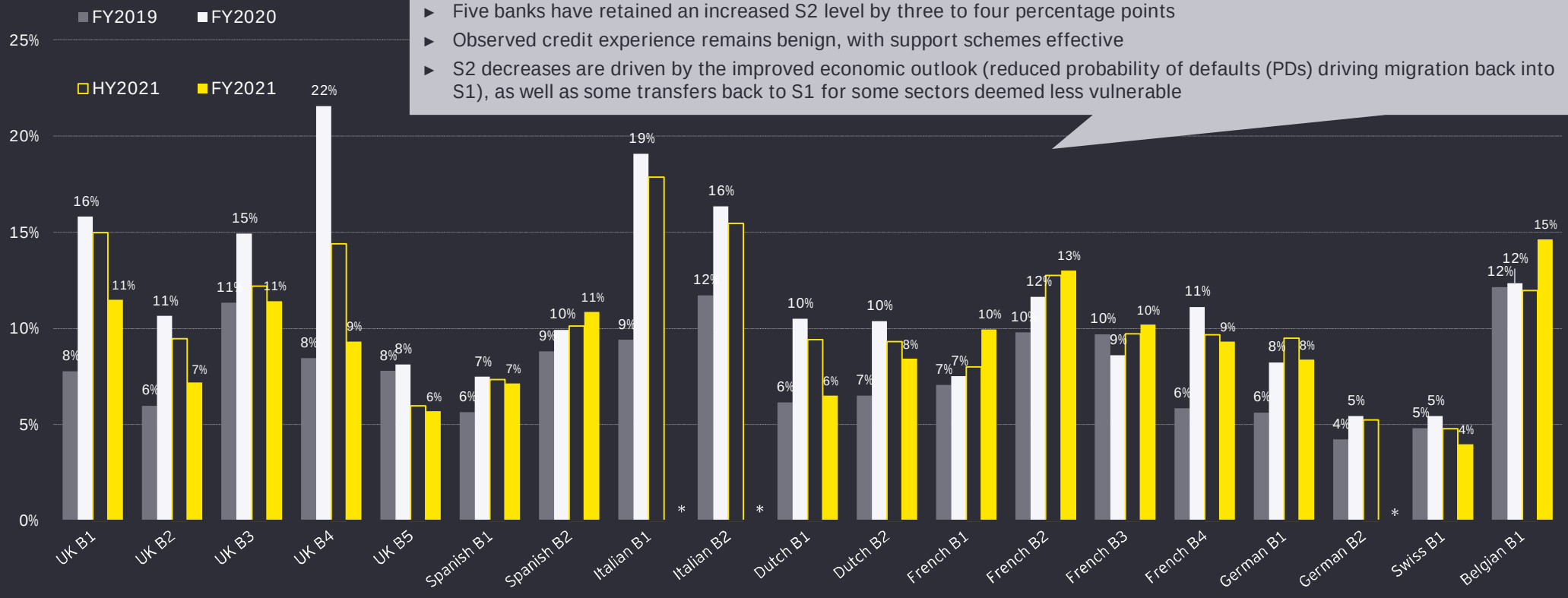




The S2 proportion of loans has generally decreased since 2020, with levels now closer to 2019

S2 loans % = S2 loans as a proportion of S1 and S2 loans to customers (in %) (*)

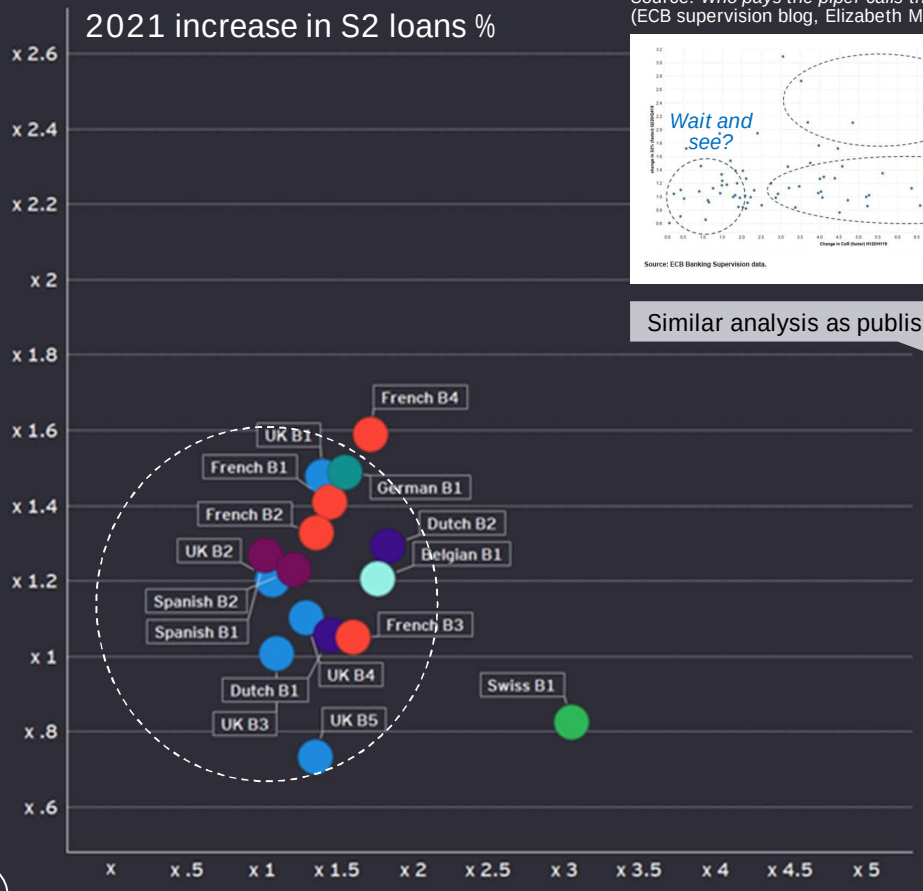
- Between 2019 and 2021, the average S2% has increased from 7.8% to 9%, with very diverse levels of spikes in 2020
- Five banks have retained an increased S2 level by three to four percentage points
- Observed credit experience remains benign, with support schemes effective
- S2 decreases are driven by the improved economic outlook (reduced probability of defaults (PDs) driving migration back into S1), as well as some transfers back to S1 for some sectors deemed less vulnerable



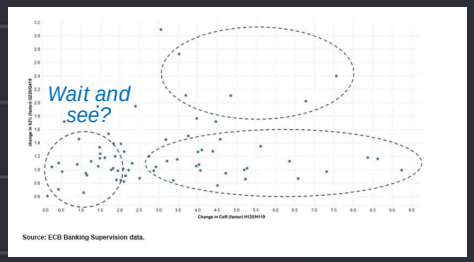
(*) Some of the banks have not yet published their Annual Reports; hence, the staging of gross loans is not yet available

Compared to year-end 2020, the ECB analysis of how banks compared on levels of increase in S2 and CoR now shows reduced dispersion

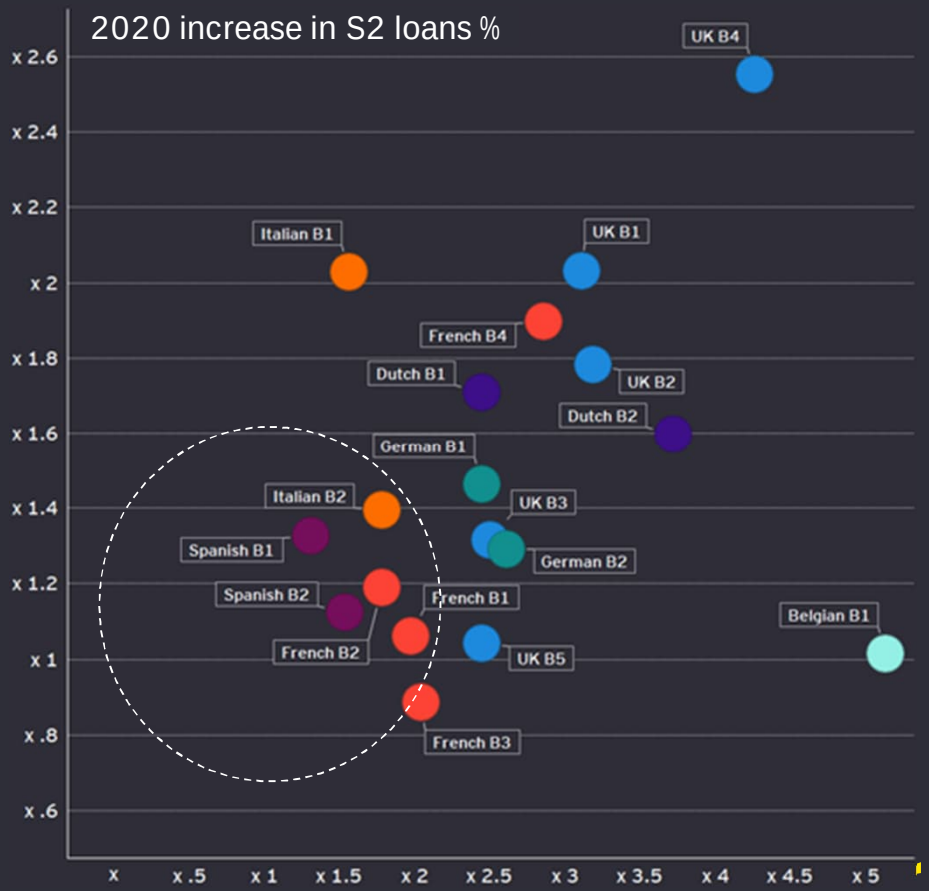
Correlation between increase in S2 loans % and increase in CoR



Source: *Who pays the piper calls the tune*
(ECB supervision blog, Elizabeth McCaul, 4 Dec. 2020)



Similar analysis as published by ECB



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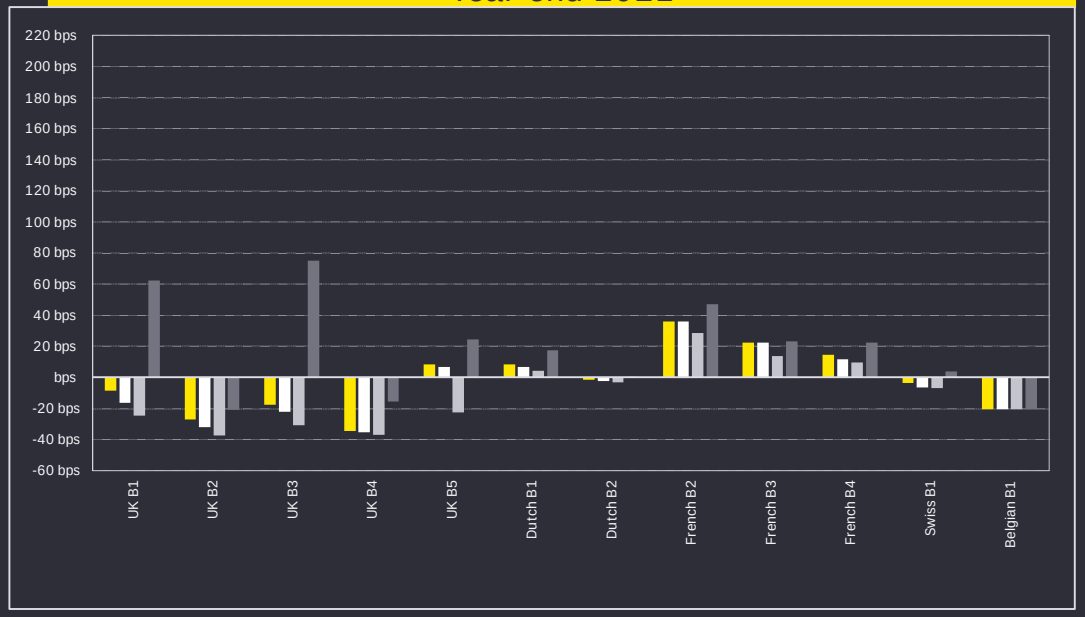
The amplitude of the sensitivities to the different scenarios in FY2021 has also reduced significantly compared to FY2020

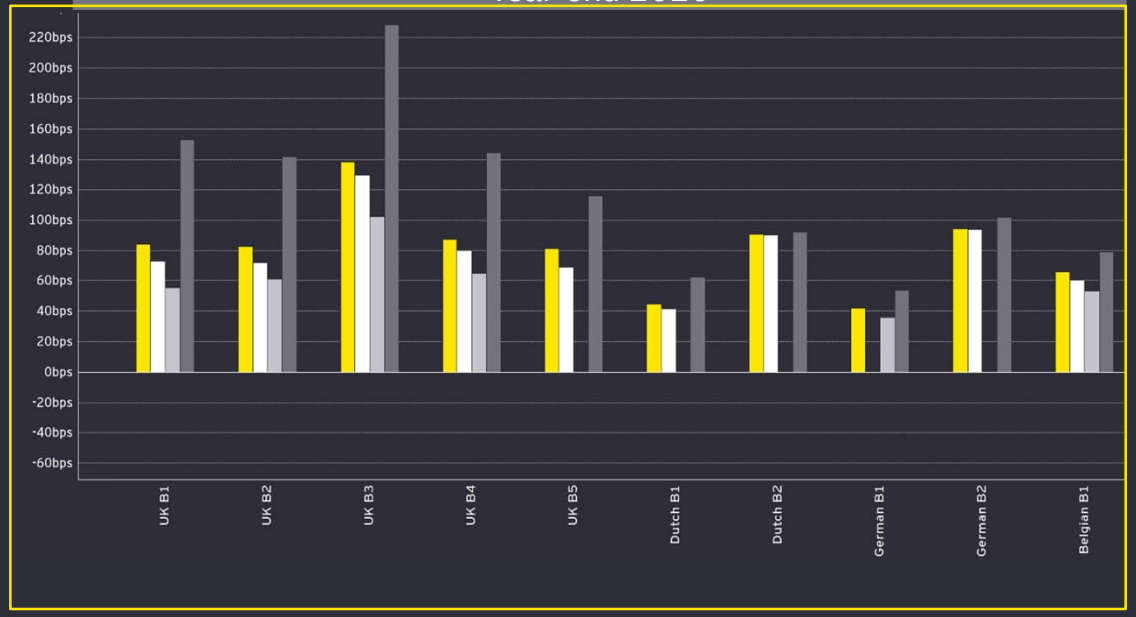
CoR of alternative scenarios: actual/baseline/mild downside/severe downside

Year-end 2021



- Actual (probability weighted)
- Severe downside scenario (weighted at 100%)
- Upside scenario (weighted at 100%)
- Baseline scenario (weighted at 100%)

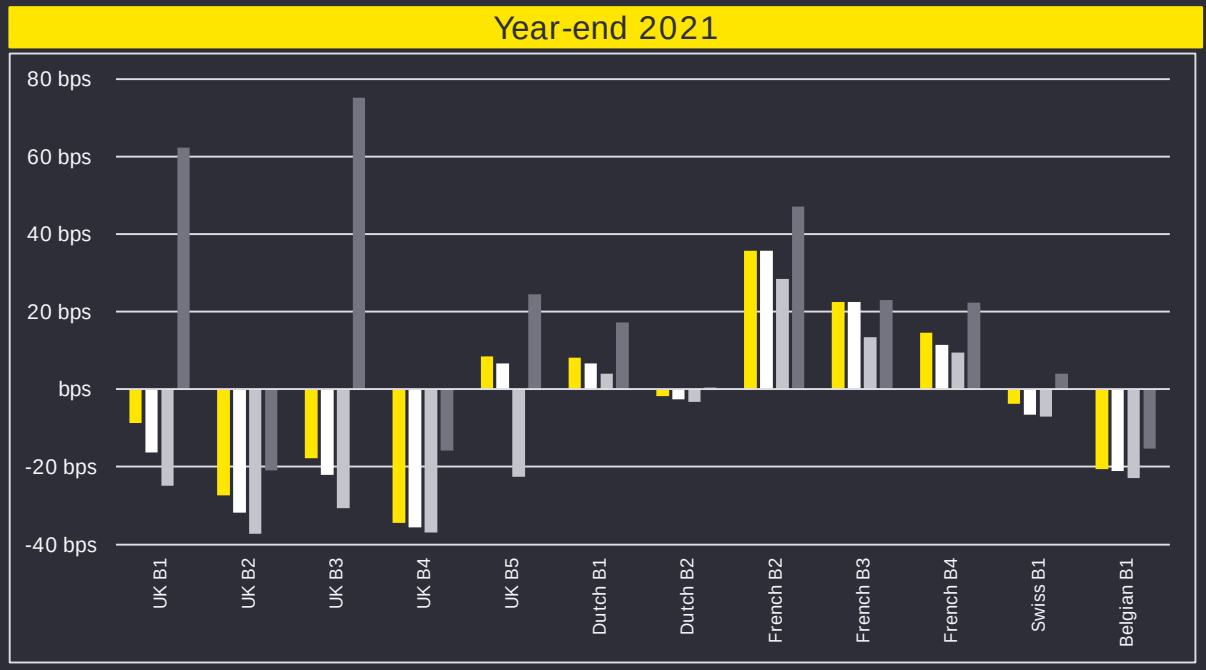
Year-end 2020



- Actual (probability weighted)
- Severe downside scenario (weighted at 100%)
- Mild downside scenario (weighted at 100%)
- Baseline scenario (weighted at 100%)

But the differences between banks reveal the complexity of ECL comparisons around forward-looking components of the IFRS 9 model

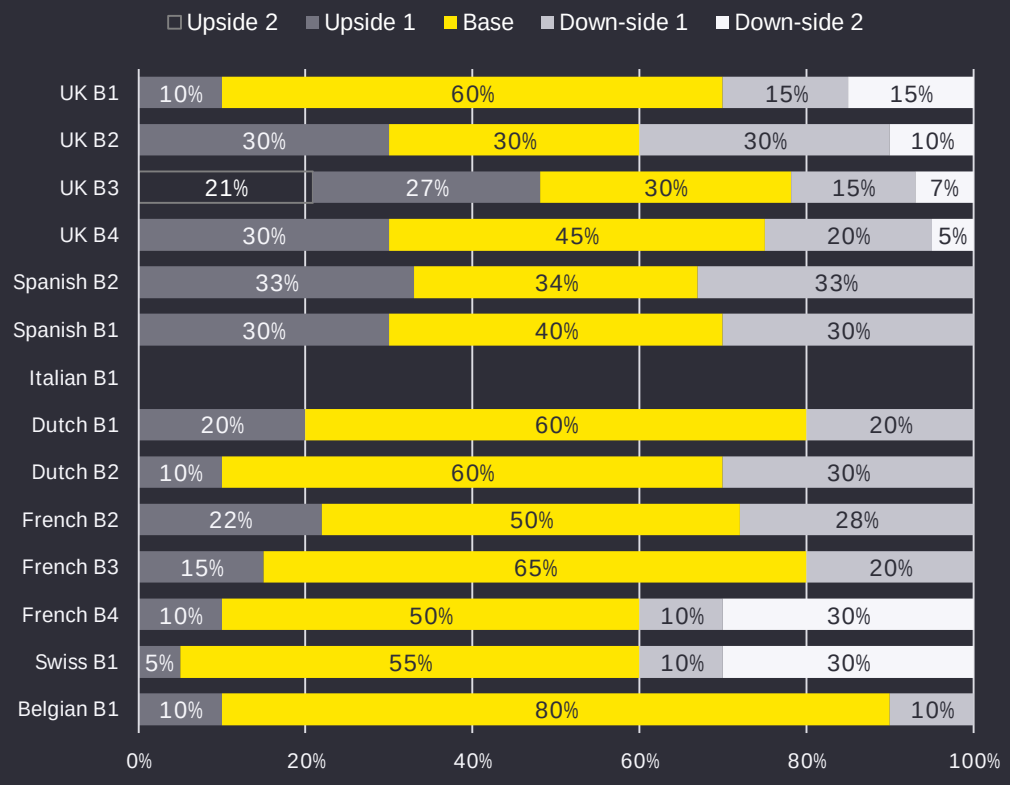
CoR of alternative scenarios: actual/baseline/mild downside/severe downside



- More banks are now disclosing sensitivity analysis showing alternative ECL calculations based on each alternative scenario being 100% weighted
- However, comparing the sensitivity of the scenarios between banks is difficult due to differences in methodologies. For example:
  - Some banks include overlays in the analysis and others exclude them
  - Some banks include their entire portfolio in the analysis whereas others excludes certain parts
- On average the sensitivity seems higher for UK banks than for those in the rest of Europe.

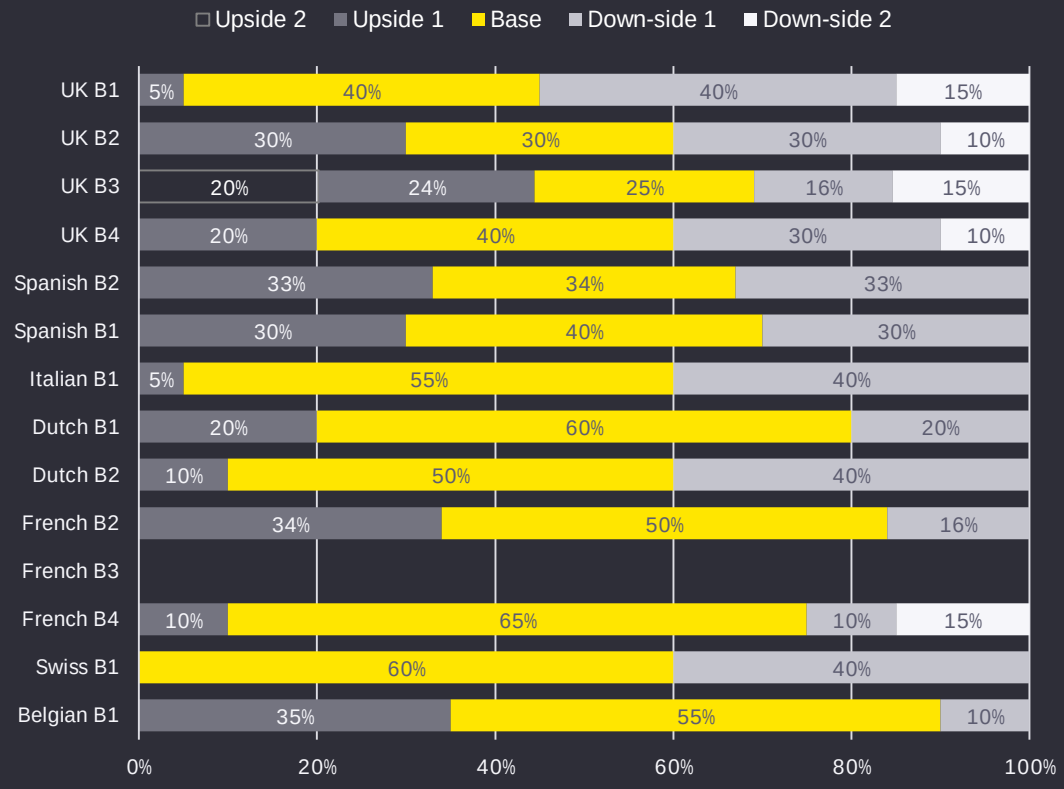
Weighting of scenarios have remained fairly stable, with on average a higher weight to the baseline and lower to the downside scenario

Year-end 2021



Averages: Baseline = 51% Downside = 27% Upside = 22%

Year-end 2020

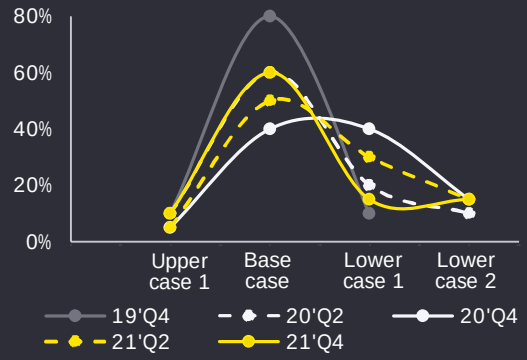


Averages: Baseline = 46% Downside = 30% Upside = 23%

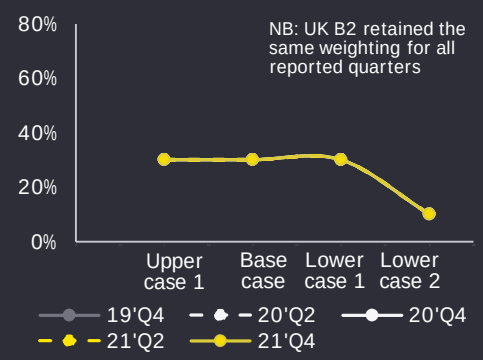
Some banks have significantly rebalanced the weights of their alternative scenarios while others have kept them stable across the crisis

Macroeconomic scenario (MES) weightings: Q4 2019, Q2 2020, Q4 2020, Q2 2021 and Q4 2021 – UK, Spanish and Italian banks

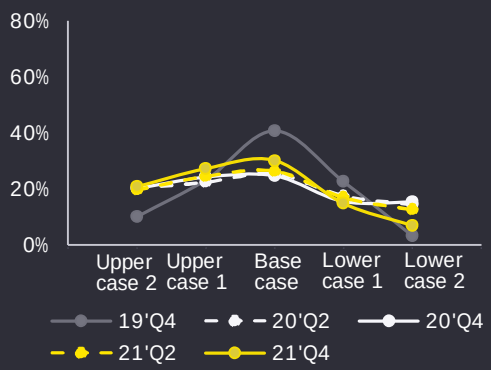
UK B1 MES weightings



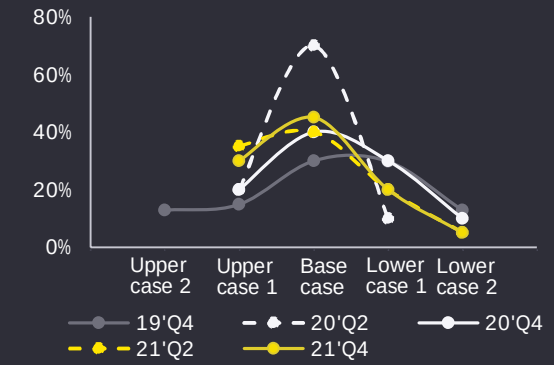
UK B2 MES weightings



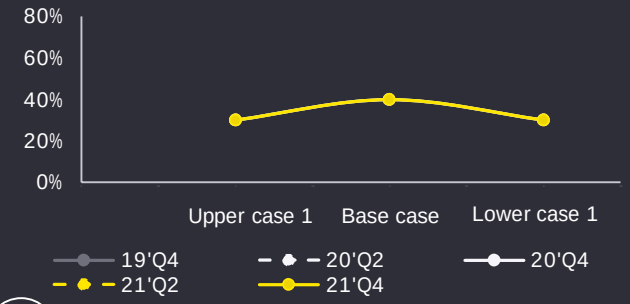
UK B3 MES weightings



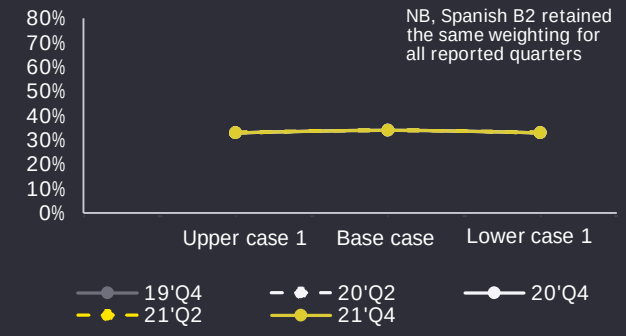
UK B4 MES weightings



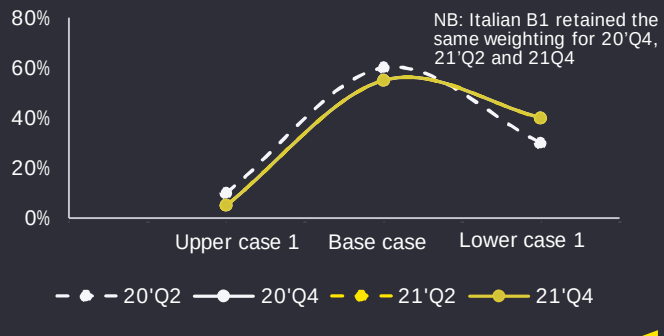
Spanish B1 MES weightings



Spanish B2 MES weightings



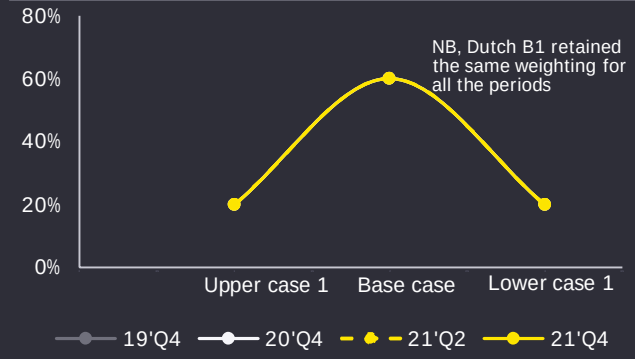
Italian B1 MES weightings



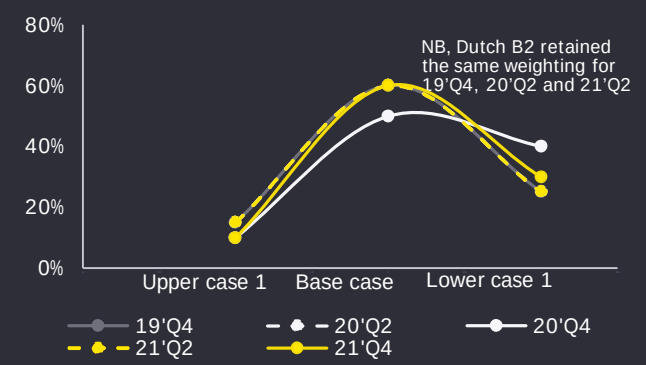
Some banks have significantly rebalanced the weights of their alternative scenarios while others have kept them stable across the crisis

Macroeconomic scenario (MES) weightings: Q4 2019, Q2 2020, Q4 2020, Q2 2021 and Q4 2021 – Eurozone and Swiss banks

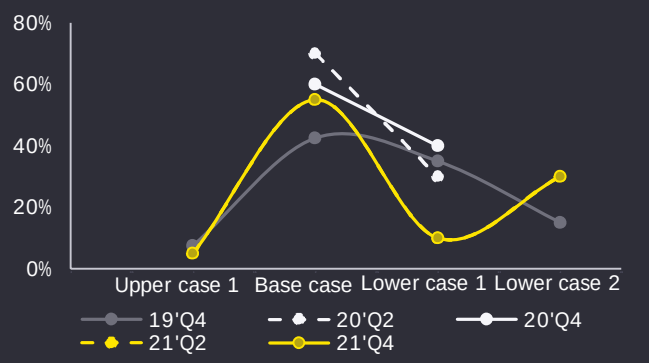
Dutch B1 MES weightings



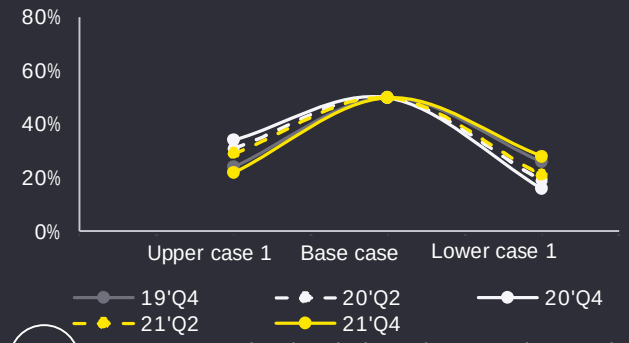
Dutch B2 MES weightings



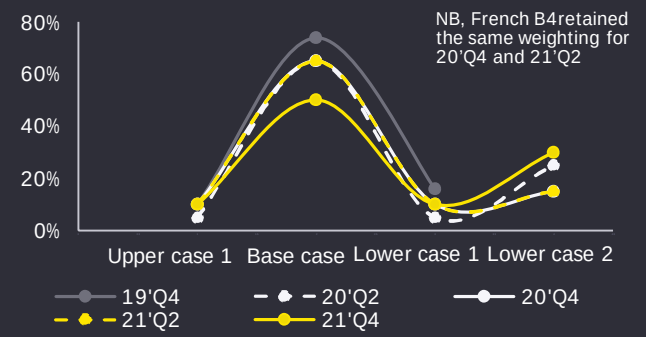
Swiss B1 MES weightings



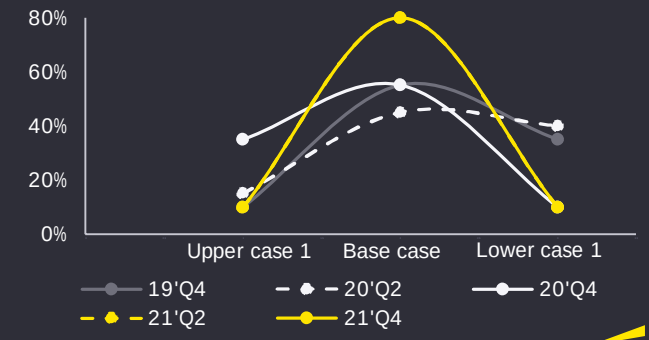
French B2 MES weightings



French B4 MES weightings

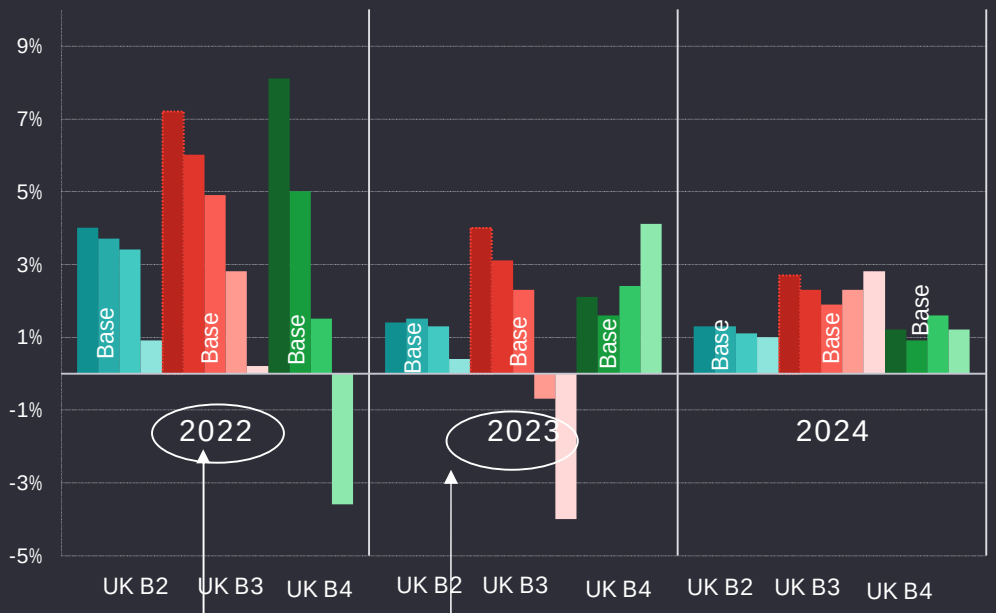


Belgian B1 MES weightings

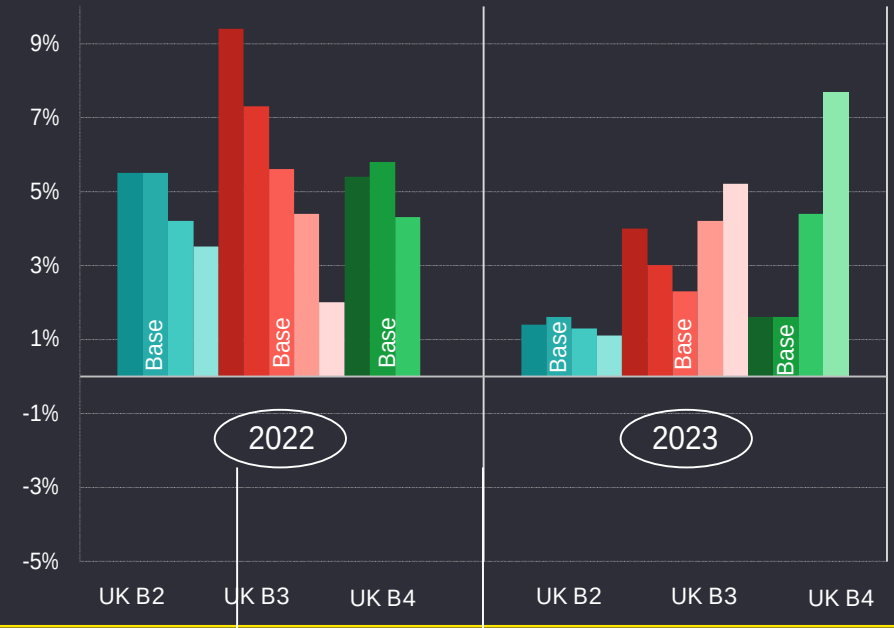


Since half year, UK banks have deteriorated their multiple scenarios, but comparisons reflect very different levels of variance across banks

Year-end 2021 UK GDP projections: 2022 to 2024



Half-year 2021 UK GDP projections: 2022 to 2023

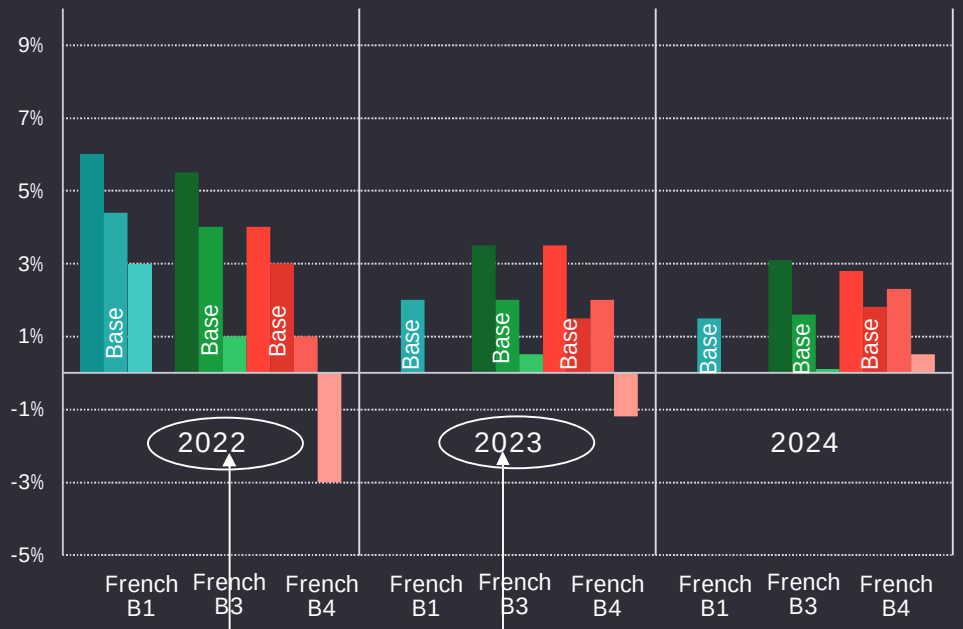


GDP assumptions have deteriorated

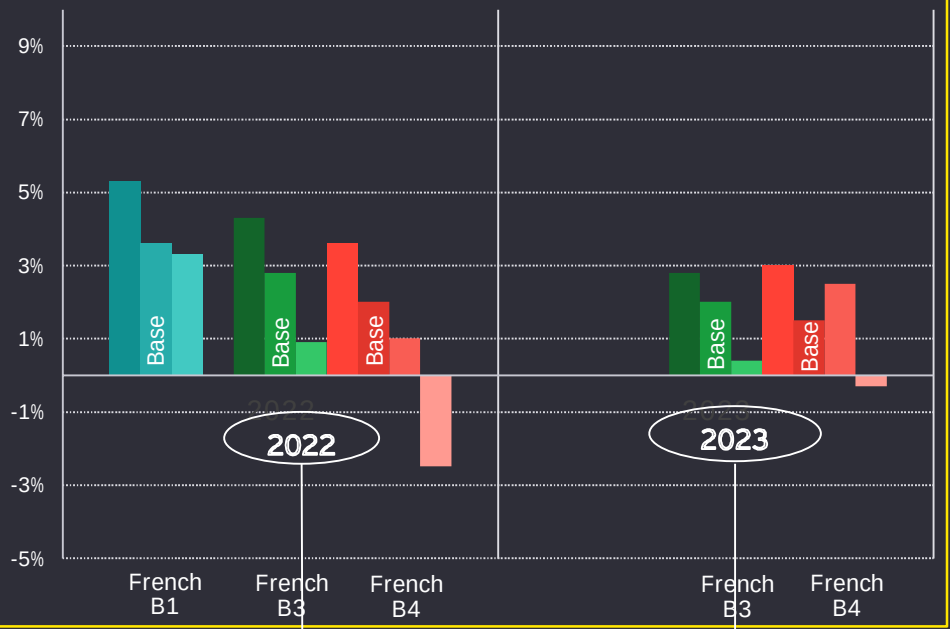
- decrease in base scenarios for the three banks, steeper for 2022 than for 2023 (where base scenarios are almost stable)
- downside scenarios are more pessimistic and upside less optimistic

In contrast, French banks have rather improved their multiple scenarios but they also show different levels of variance

Year-end 21 French GDP projections : 2022 to 2024



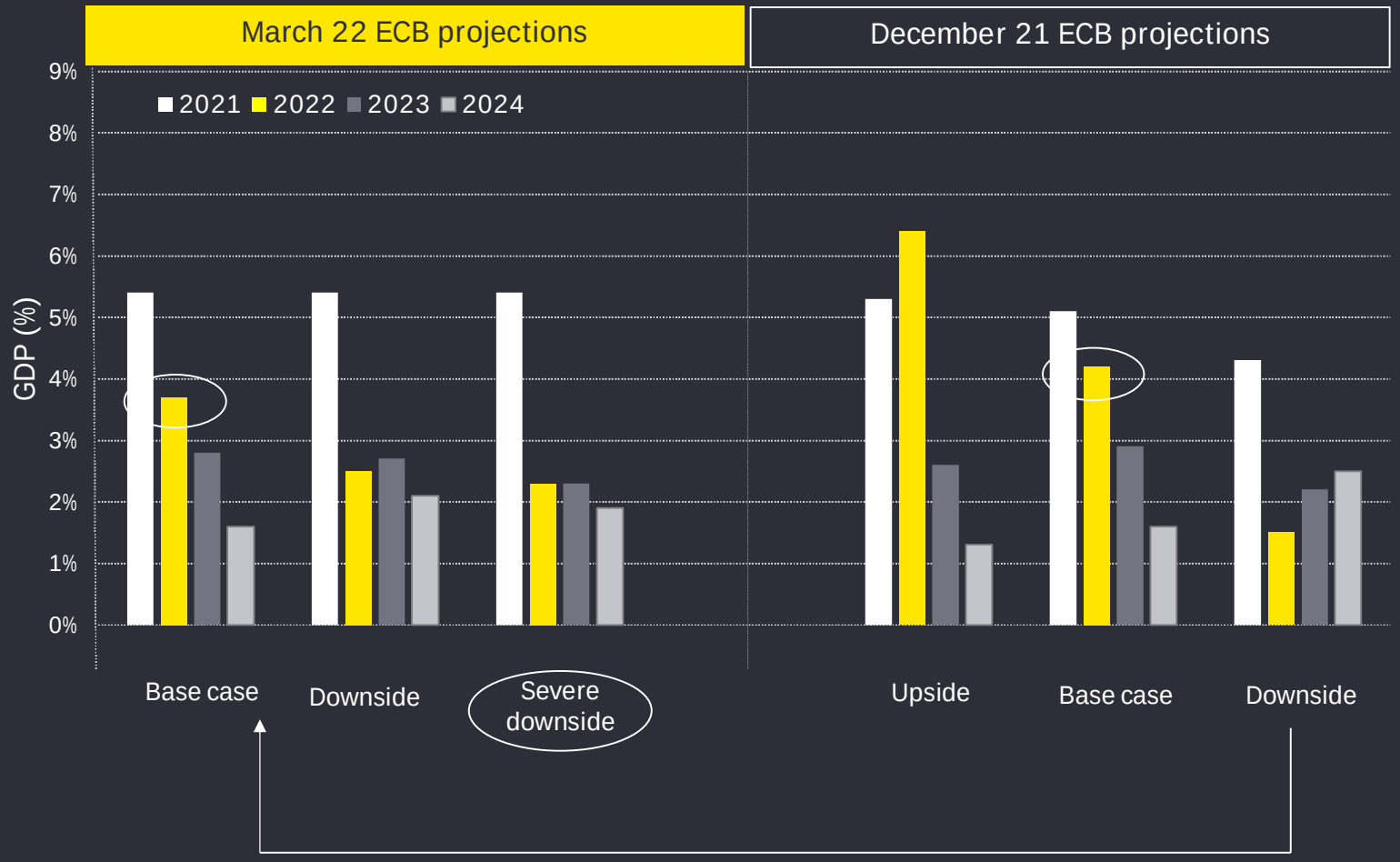
Half-year 2021 French GDP projections: 2022 to 2023



GDP assumptions have improved (contrary to UK trends)

- For 2022, increase in base scenarios for the three banks
  For 2023, base scenarios are stable for B3 and B4)
- Upside scenarios are more optimistic (for 2022 and 2023) ; divergence in trends for downside

March 2022 ECB macroeconomic projections reflecting the effects of the war in Ukraine project a lower growth for 2022, but growth is still expected to be robust



- The war in Ukraine makes the near future very uncertain
  - The Russian invasion of Ukraine makes energy more expensive, disrupts trade and weighs on people's confidence
  - Economic growth will be slower than was expected before the outbreak of the war
- The economy should still grow robustly in 2022
- An "adverse" scenario assumes that stricter sanctions are imposed on Russia, leading to some disruptions in global value chains
- A more "severe" scenario adds a stronger reaction of energy prices to more stringent cuts in supply, stronger repricing in financial markets and larger second-round effects from rising energy prices

Source: *ECB staff macroeconomic projections for the euro area*. Mar 2022 link here

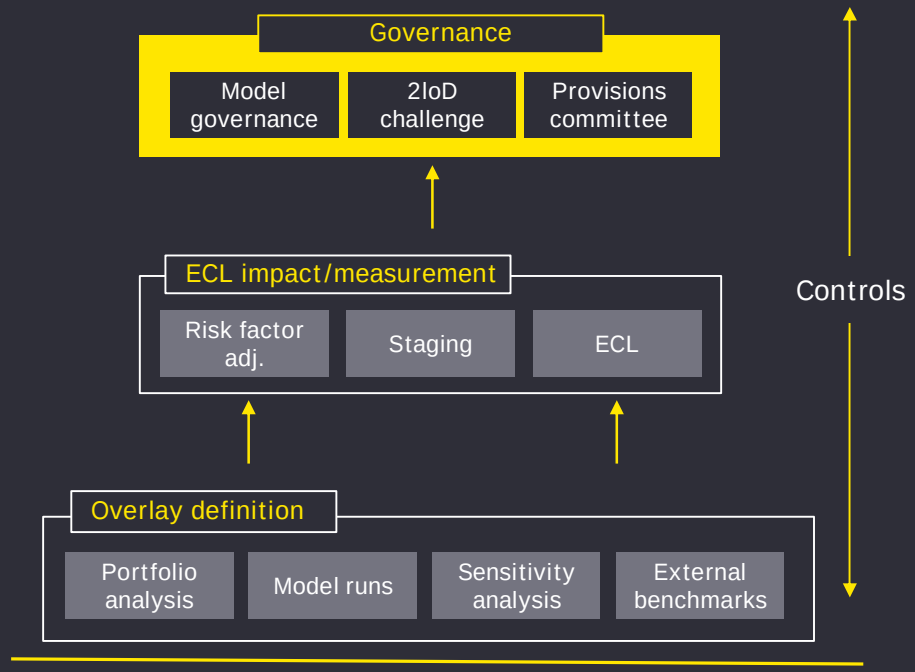
Uncertainty is the only certainty

As the global economy start to emerge out of the pandemic a number of new headwinds have emerged, which may not necessarily be adequately captured by the current IFRS 9 model suit requiring further overlays

Emerging headwinds....

- ? The war in Ukraine could take a number of broad paths - but there is no return to “business-as-before”
- ? Heightened geopolitical tensions impacting the global trade
- ? Prolonged and sustained high inflation subdued economic growth (stagflation)
- ? Further COVID-19 social restrictions, and lockdowns
- ? Climate risk and strategy

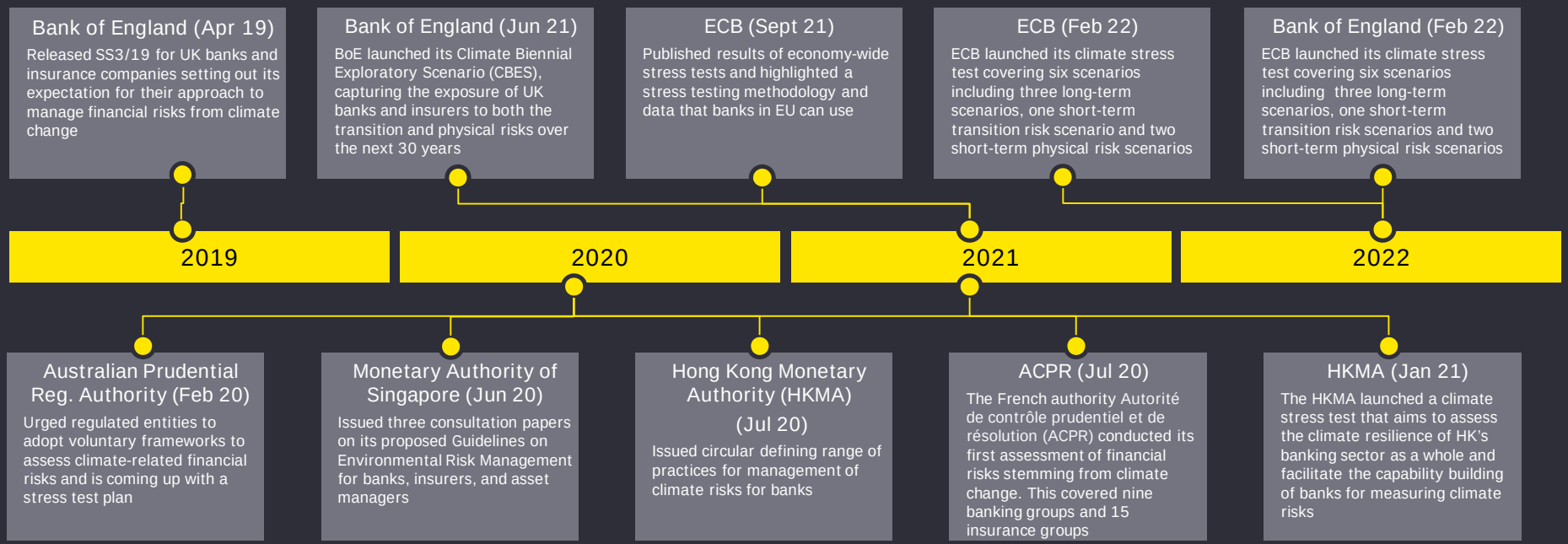
IFRS 9 overlay framework



Regulatory climate stress tests

Over the years global regulatory authorities have both issued guidance, policy statements and conducted exploratory climate stress tests. Translation into capital and provisioning is yet to emerge, classification and measurement thinking continues to evolve.

Sample of regulatory guidance and stress exercises



Over 20 climate stresses conducted globally during 2021, with 10 currently planned for 2022

ECB's recent publications

The ECB views climate-related and environmental risks as key risk drivers for the banking sector, both now and in the future and continue to expect significant investment to enhance capability to measure and manage climate risk.

ECB Dear CEO letter on participation in the 2022 ECB Climate Risk Stress Test

- The aim of the exercise is to identify vulnerabilities, industry best practices and the challenges faced by banks. The exercise will also help enhance data availability and quality, and allow supervisors to better understand how stress testing can help gauge climate risks
- The output of the stress test exercise will be integrated into the Supervisory Review and Evaluation Process (SREP) using a qualitative approach. A possible impact of the exercise will be indirect, via the SREP scores on Pillar 2 requirements

The state of climate and environmental risk management in the banking sector

- No single supervisory mechanism (SSM) institution is close to fully aligning practices to the supervisory expectation
- Most institutions consider climate-related and environmental (C&E) risks to have a material impact on their risk profile in three-five years
- Steps are taken to adapt policies and procedures, but progress is too slow
- Few institutions have practices with a discernible impact on their strategy and risk profile
- Less than half have taken first steps to adjust their strategy
- Most institutions have a blind spot for physical and other environmental risk drivers
- Supervisors have informed banks of main shortcomings, with full review of practices in 2022

Accelerate change…

Investment to improve modeling and measurement

Translation of climate strategy into actions/impacts

Data collection, management and use strategy to support climate decisions

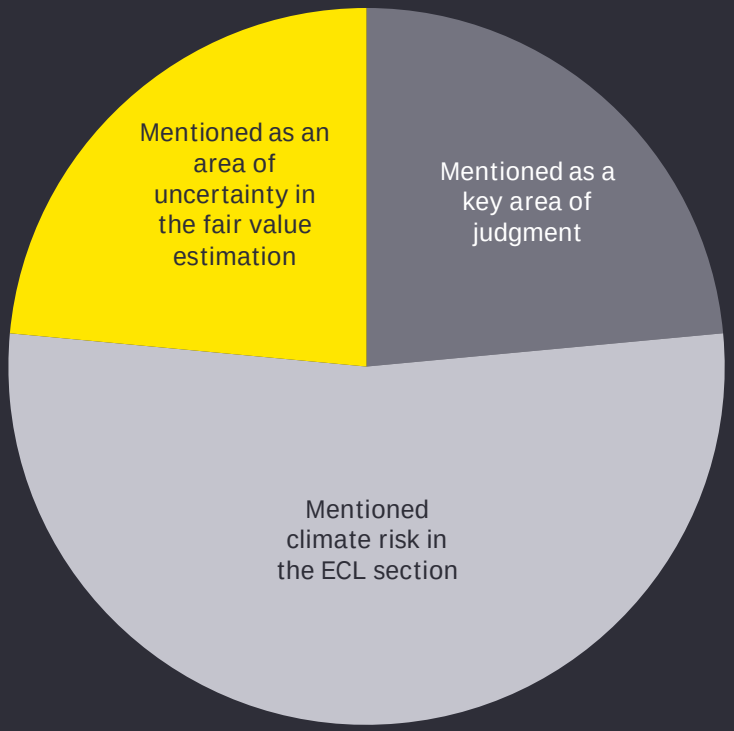
Integrate into other core bank process (e.g., financial planning, provisioning etc)

Investment in "up-skilling", attracting and retaining the necessary slides for measuring and managing climate risk

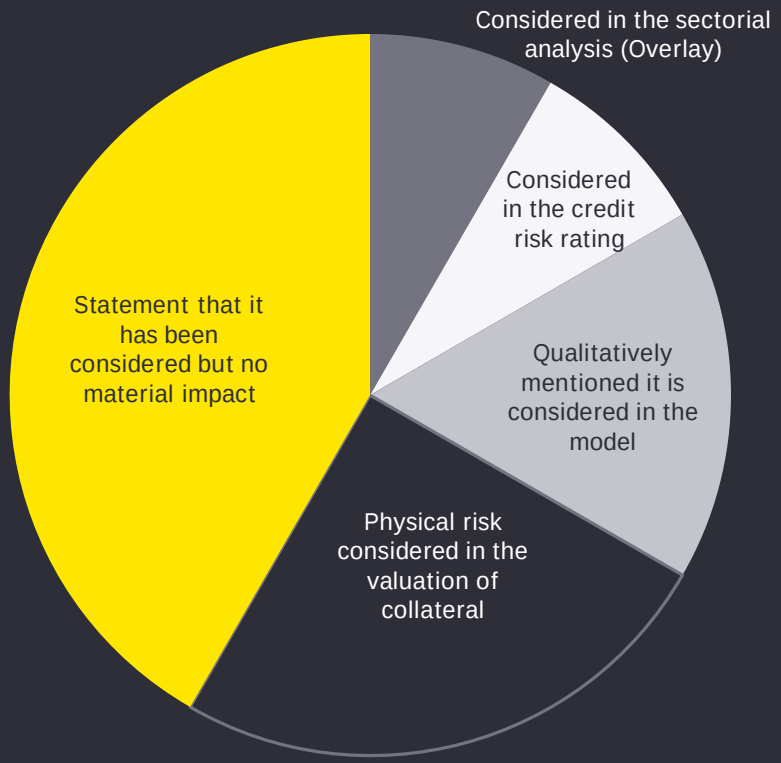
Climate risk observed in the financial statements

- This benchmark includes 11 large British and European banks
  (three French, three UK, two Italian, one Swiss, one German and one Dutch bank)

Where is climate risk mentioned within the financial statements?



How is climate risk incorporated in the ECL?



Climate risk observed in the financial statements

Risk

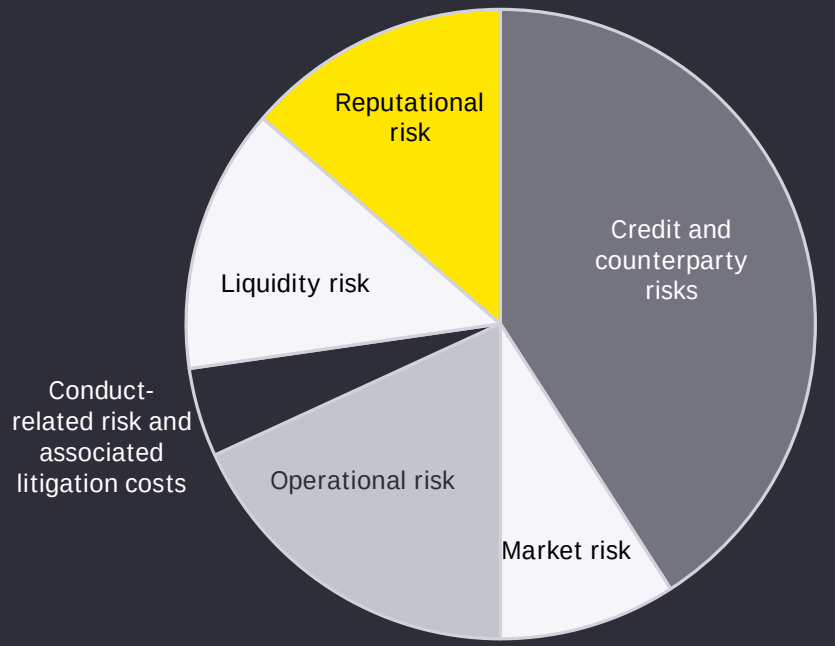
- Retail: Most banks (73%) identify mortgages as a high risk sector
- Wholesale: Sectors most sensitive to climate risk most often mentioned:
  - Automotive industry
  - Construction and materials
  - Metals and mining
  - Oil and gas
  - Real estate management / activities
  - Transport, storage and equipment

  With coal often being mentioned as being phased out by 2030

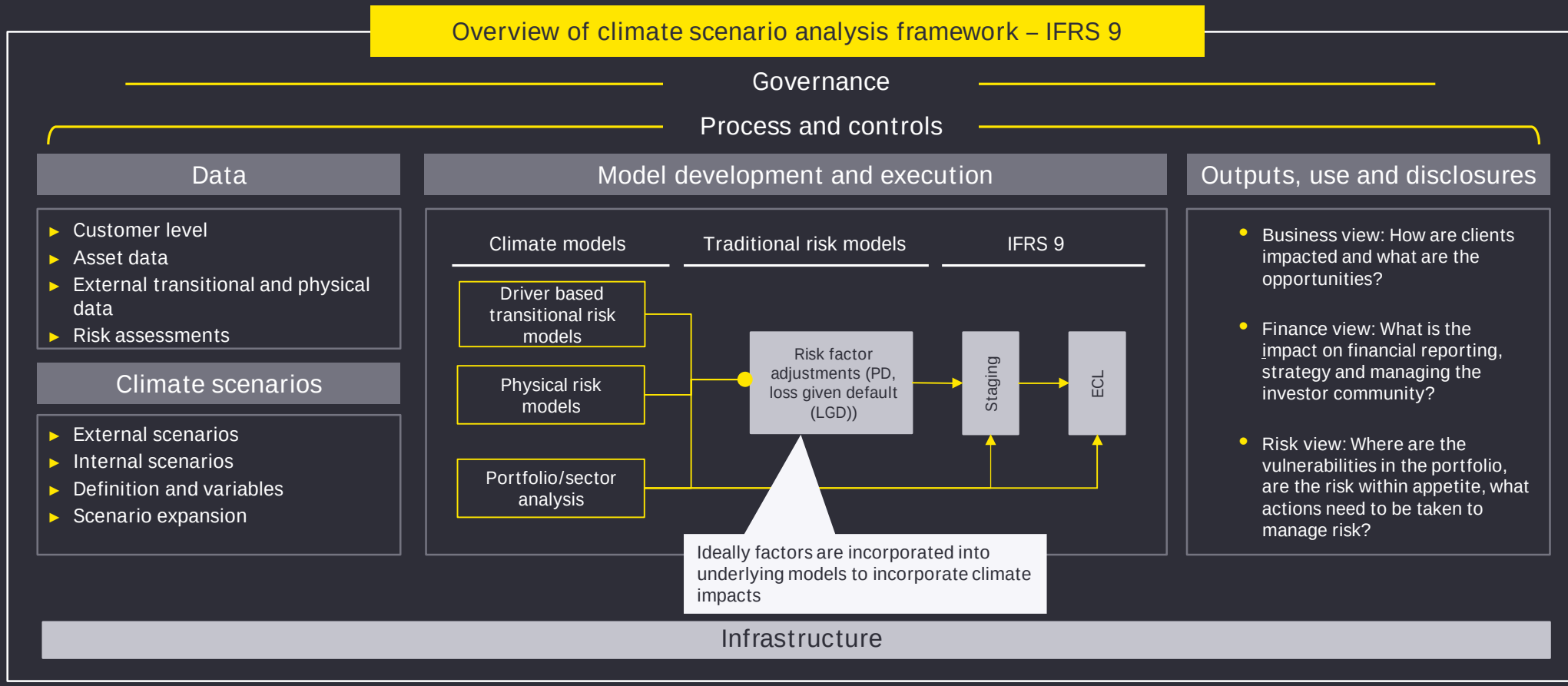
Opportunities

- Most banks identify climate risk as an opportunity to support client in the transition process and developing credible decarbonization strategies.

Climate risk translated into other risk types



Commonly used climate modeling framework

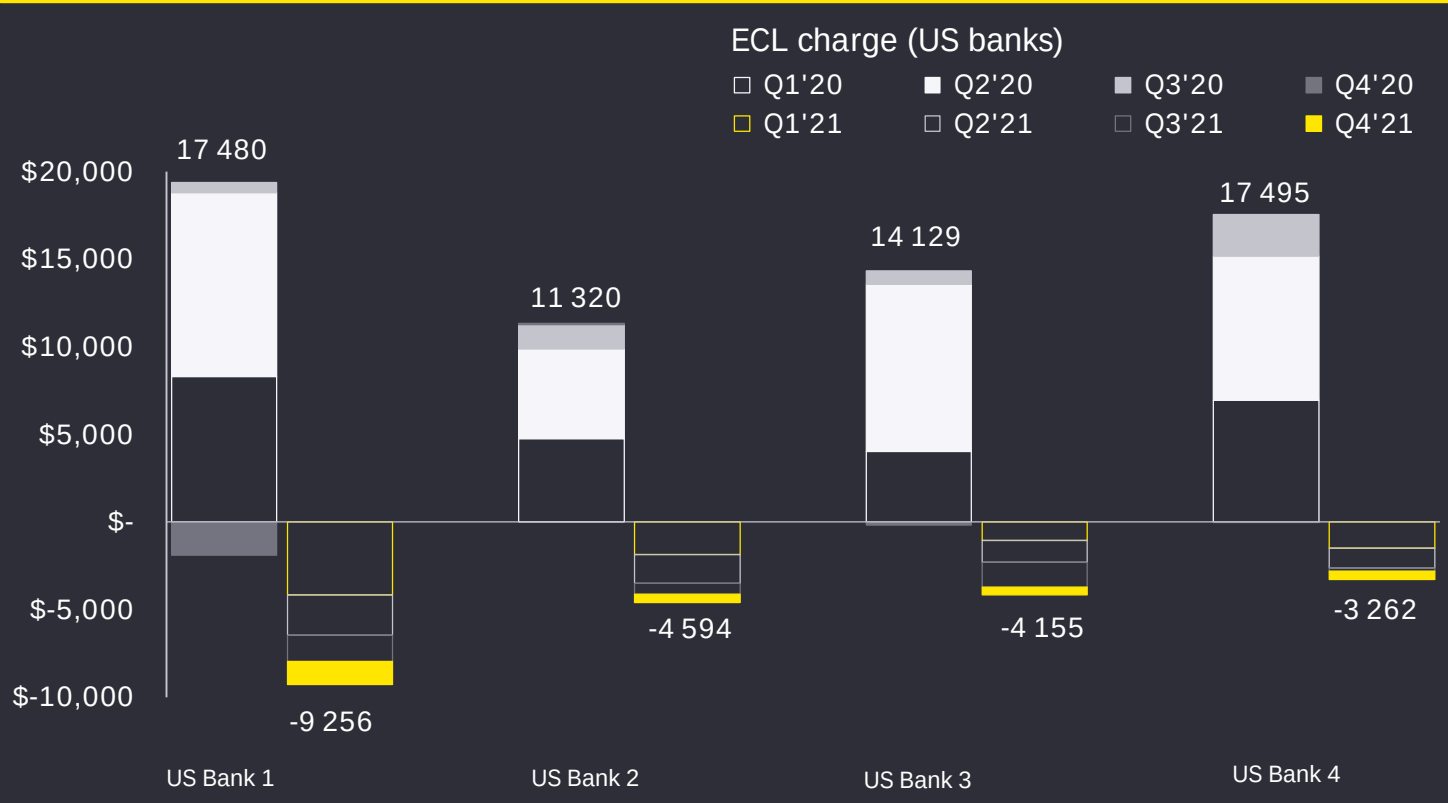


Appendix: US banks impairment results

Year-end 2021

The top-four US banks are continuing to release some ECL allowance in Q4 21, but the magnitude is decreasing

ECL P/L charge (in millions)*

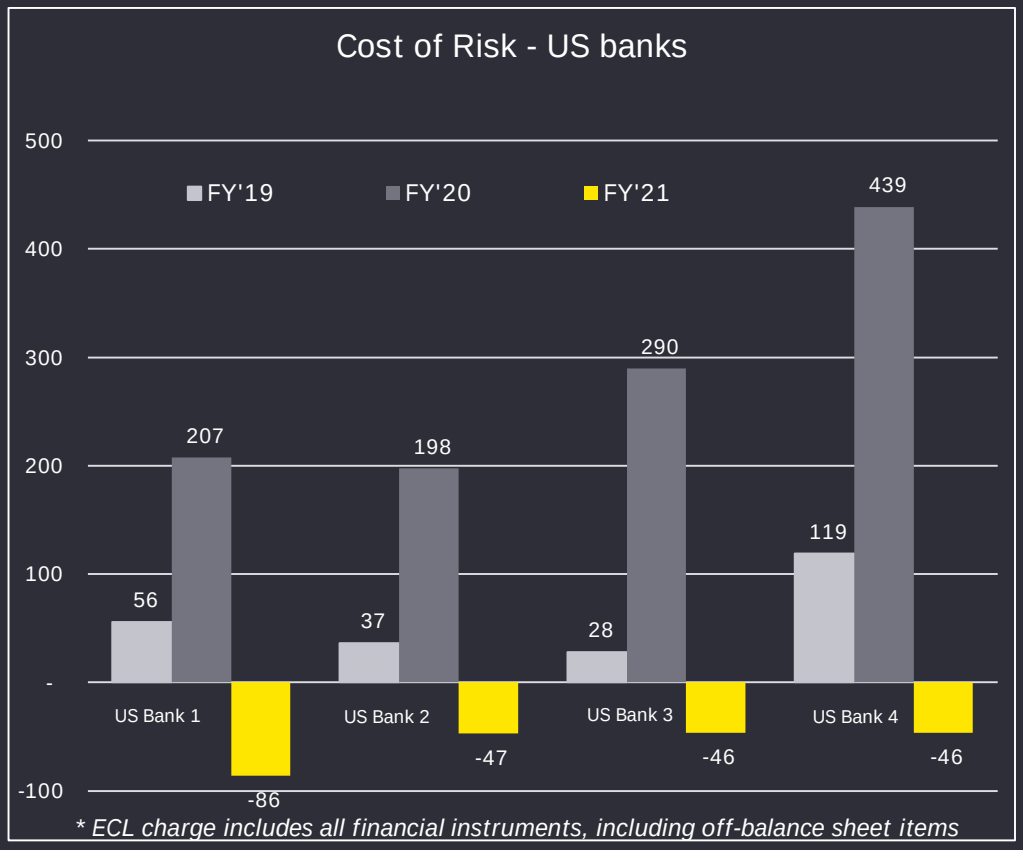


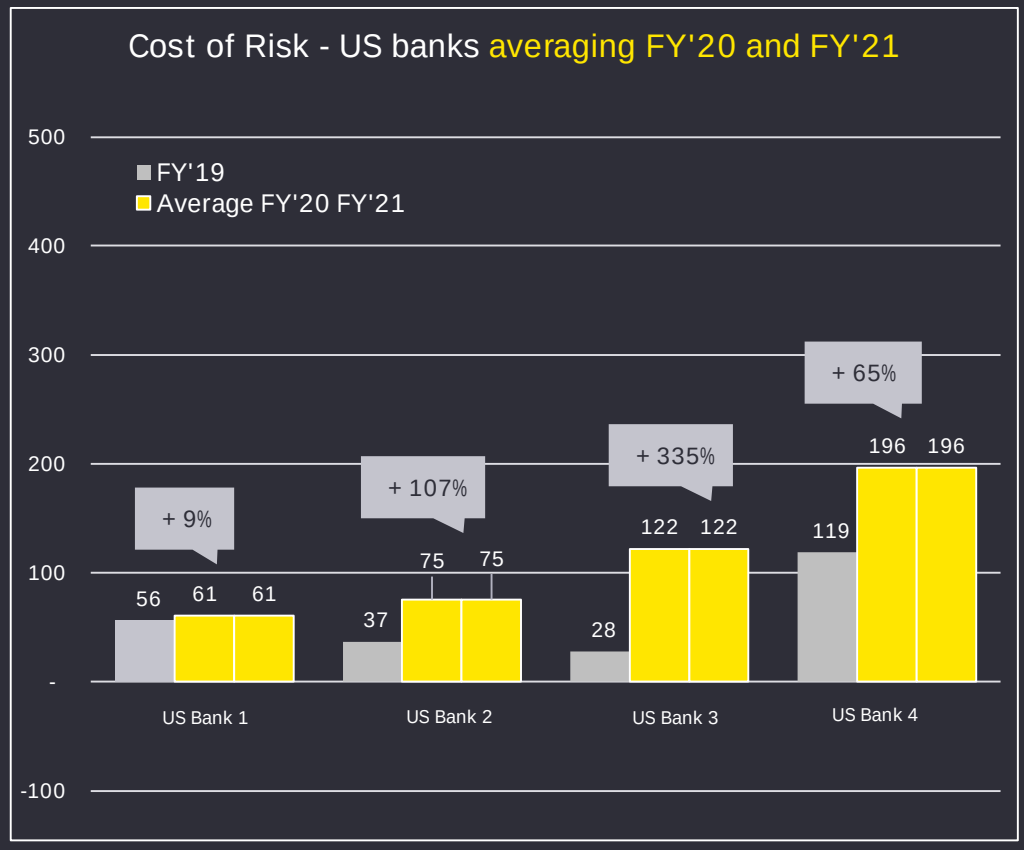
- Banks highlight a sharp increase in record consumer spend
- Most banks highlight a growth in loan volumes
- Banks are predicting a normalization of credit risk (charge-offs) in the middle term, going back to pre-pandemic levels

* ECL charge includes all financial instruments, including off-balance sheet items

After a spike in 2020, the top-four US banks have negative CoR ratios over 2021 Averaging the CoR of 2020 and 2021 highlights significant differences between banks

CoR = ECL P/L charge/gross loans to customers (in bps)*

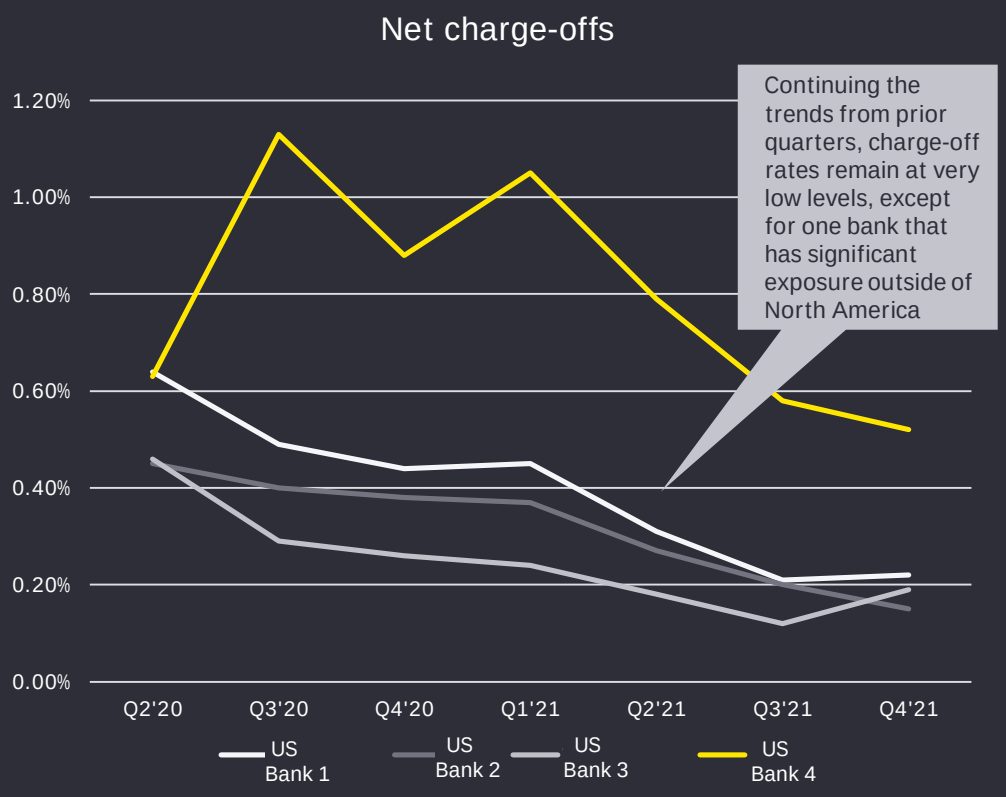




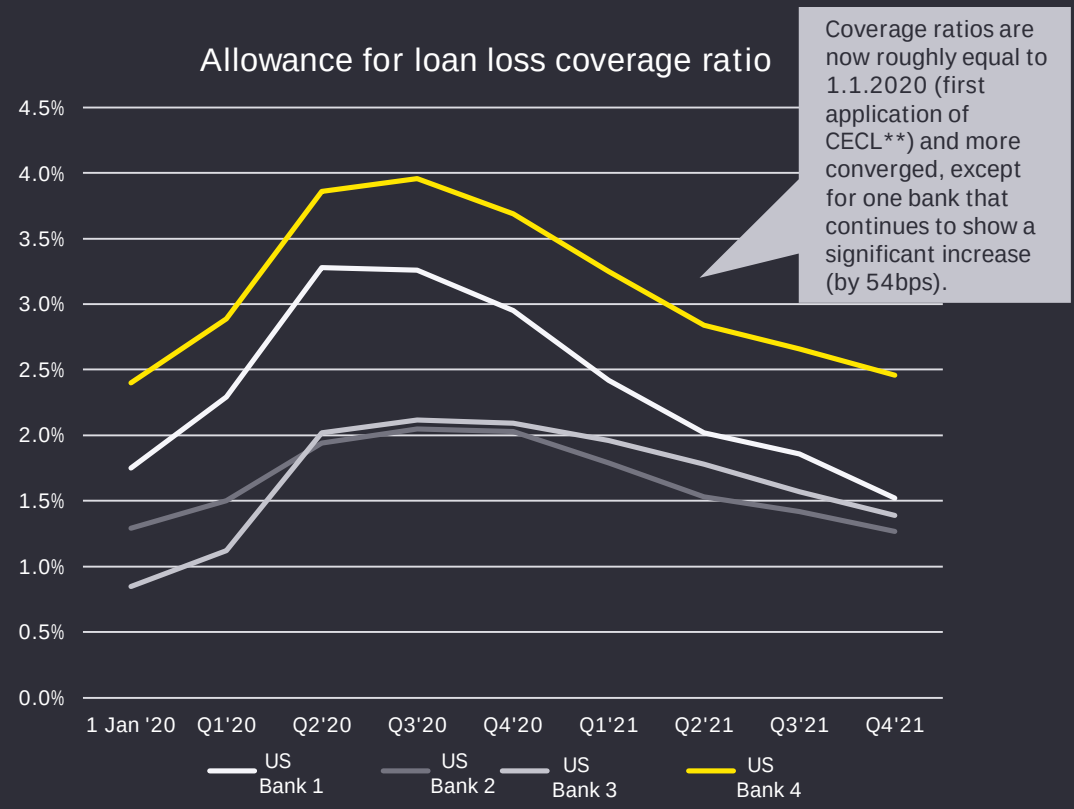
** ECL charge includes all financial instruments, including off-balance sheet items*

Similarly, net charge-offs and coverage ratios continue to decrease for the top-four US banks

Net charge-offs



Allowance for loan loss coverage ratio*

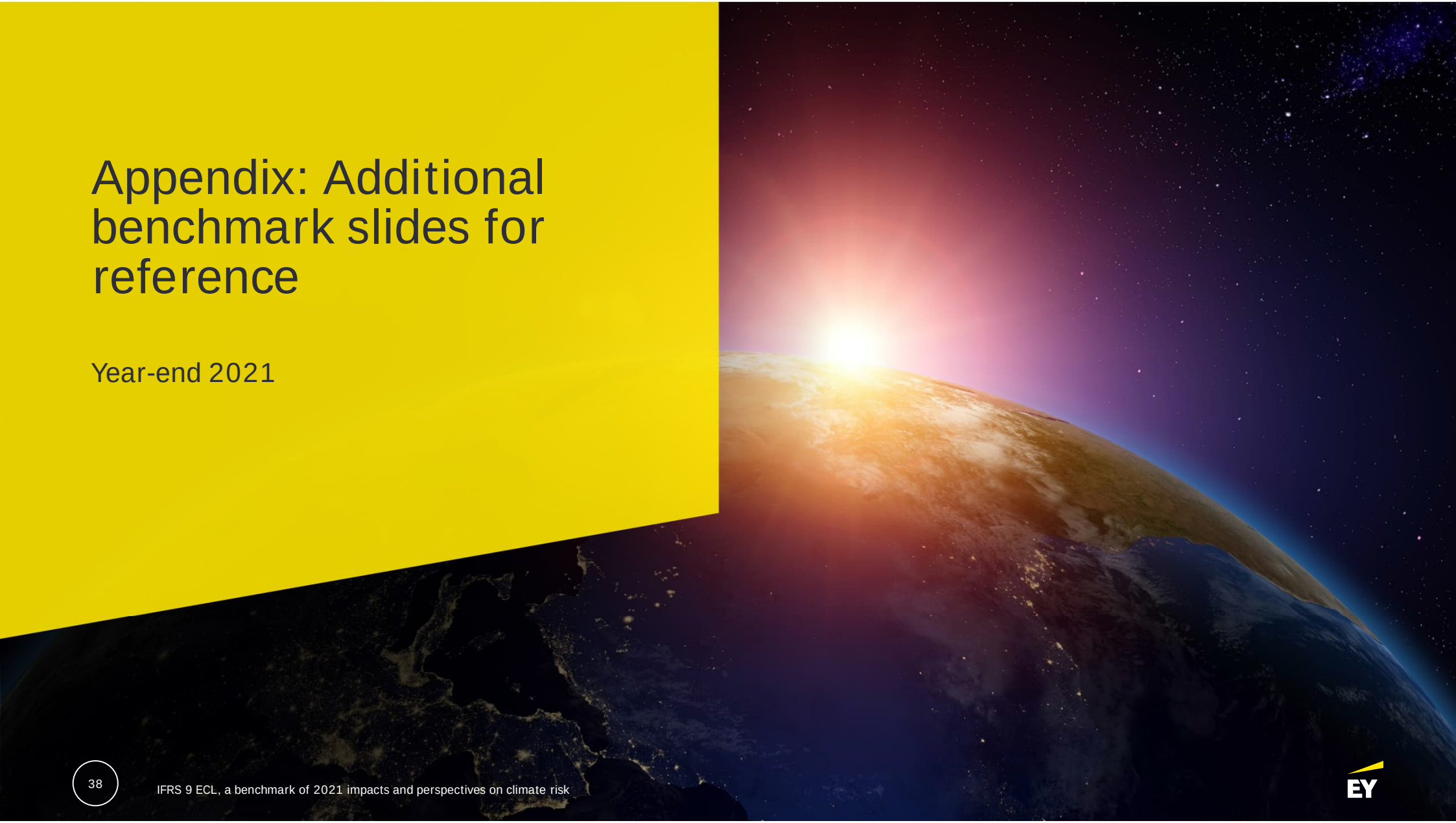


**Relates to loans only (Allowance on loans on-balance sheet (BS) / total loans on-BS)*

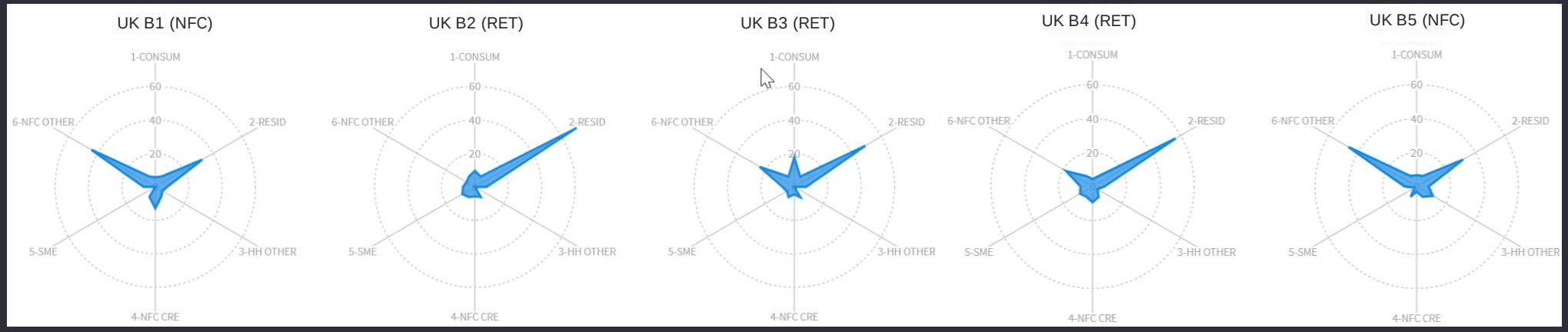
***Current Expected Credit Losses (CECL)*

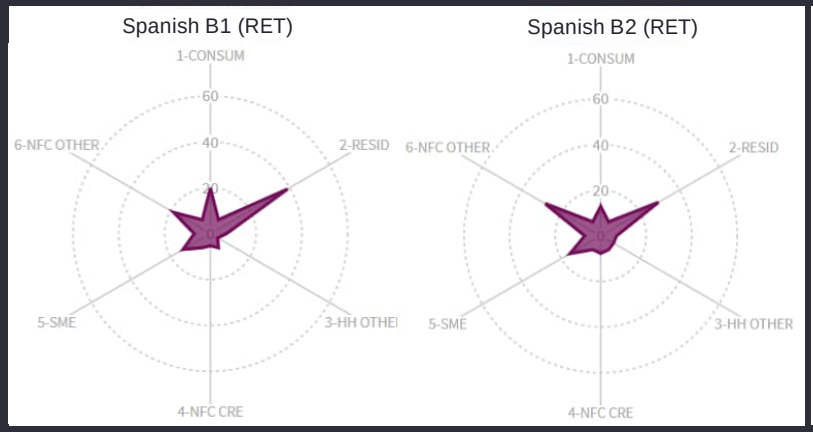
Appendix: Additional benchmark slides for reference

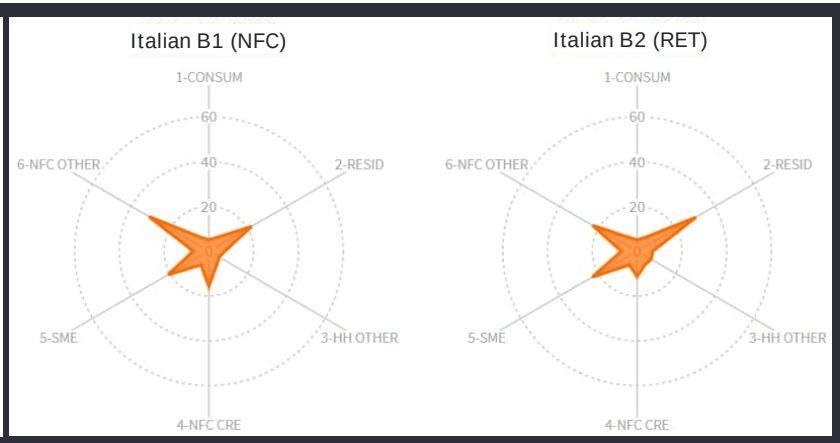
Year-end 2021



Benchmark analysis based on a sample of 19 European banks with various portfolio profiles and geographical footprints (1/2)





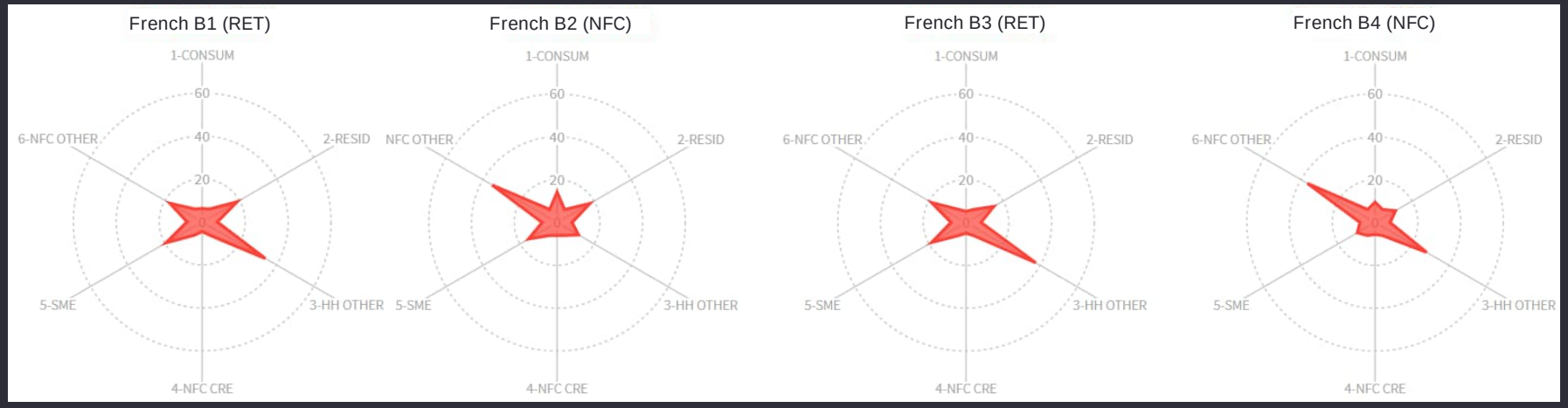


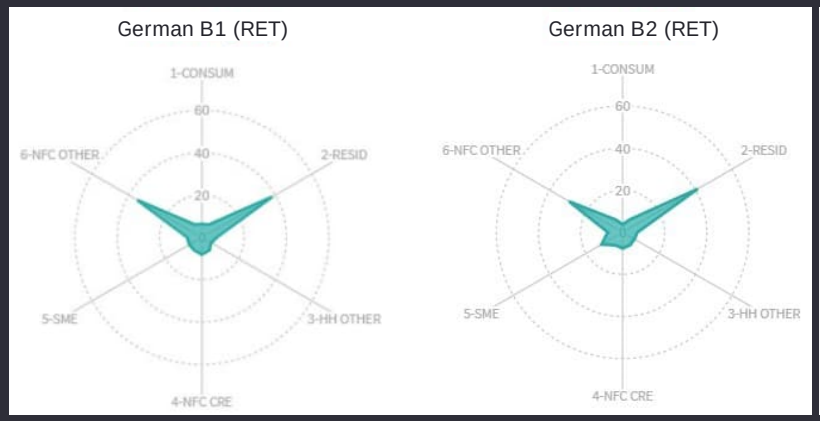
RET: Retail
NFC: non-financial corporations

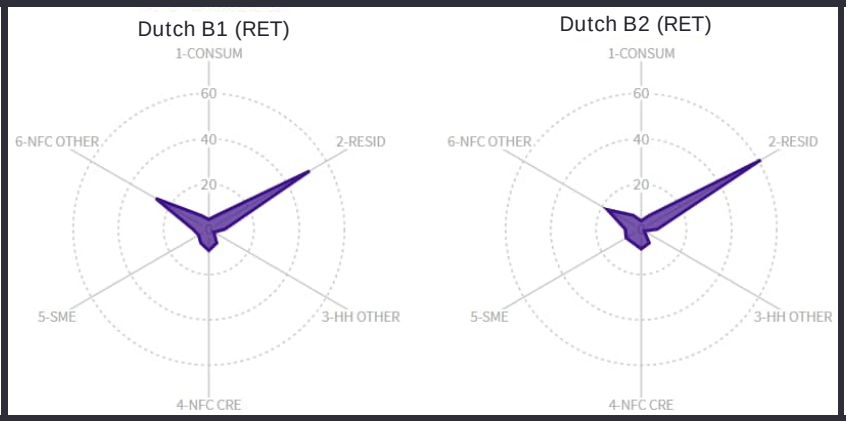
1. CONSUM: Credit for consumption
2. RESID: Collateralized by residential immovable property
3. HH OTHER: Households other
4. NFC CRE: Collateralized by commercial immovable property
5. SME: Small-and medium-sized enterprizes
6. NFC OTHER: Nonfinancial corporations other

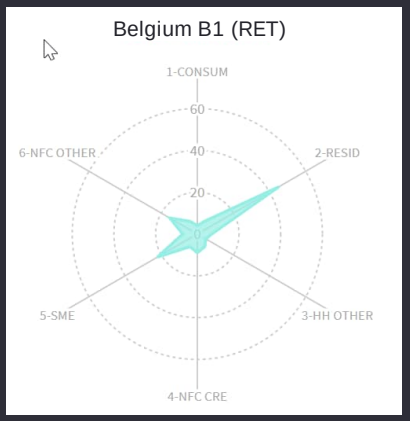
Source: EBA transparency exercise – 31/12/2020

Benchmark analysis based on a sample of 19 European banks with various portfolio profiles and geographical footprints (2/2)





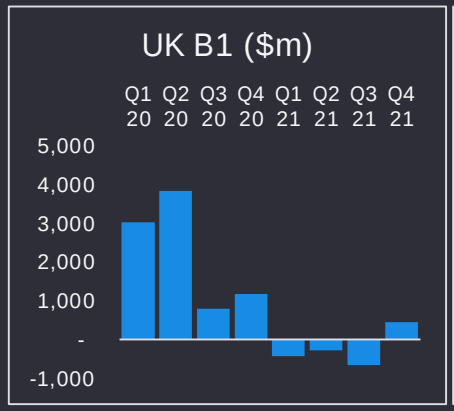


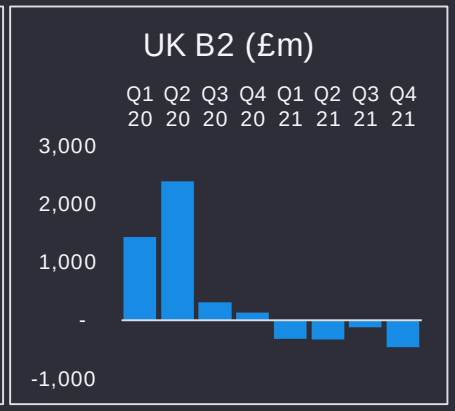


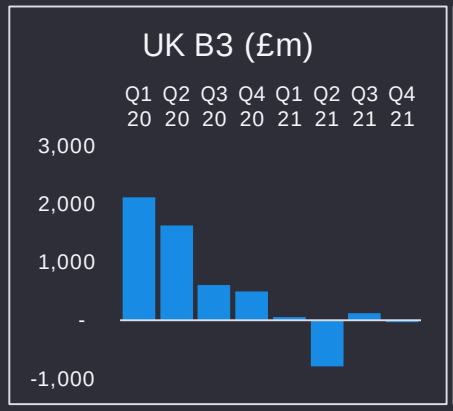
Source: EBA transparency exercise – 31/12/2020

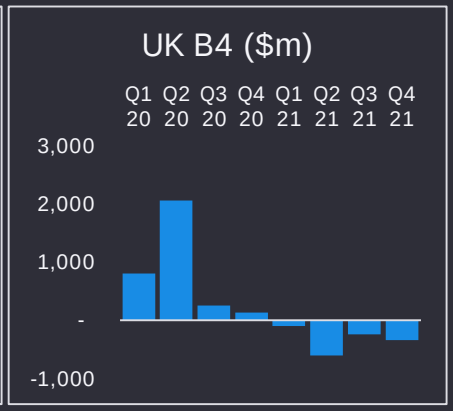
At bank level, the quarter on quarter pattern of ECL P/L charge shows that some banks took most of the hit in first-half 2020 and released in some quarters in 2021…

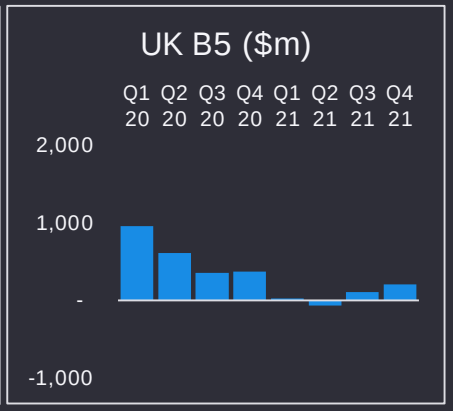
Note: the scales are adjusted to each bank's P/L impacts to emphasize each bank's own P/L dynamics across quarters

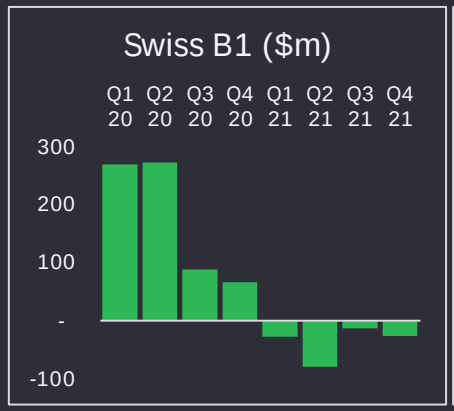


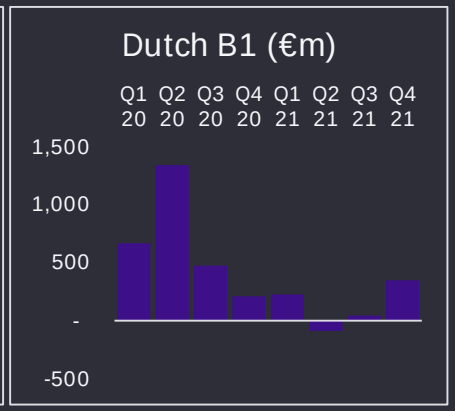


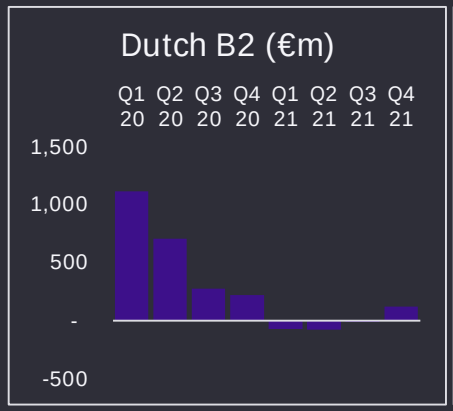


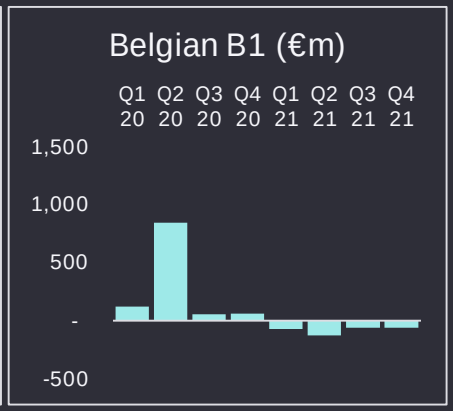






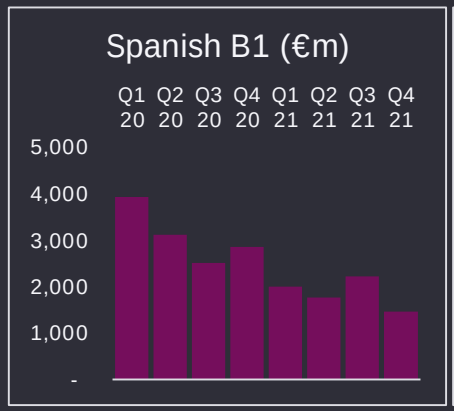


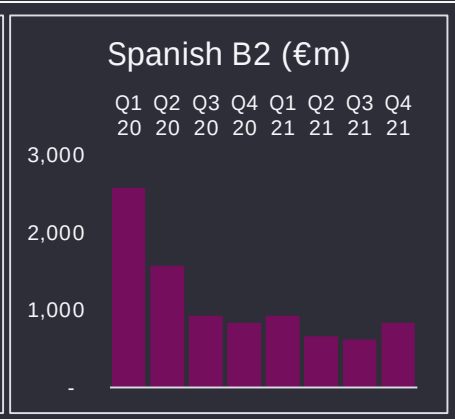


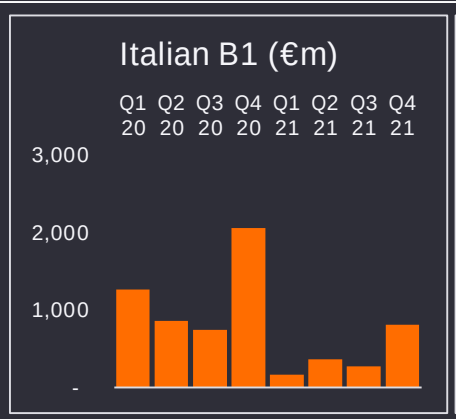


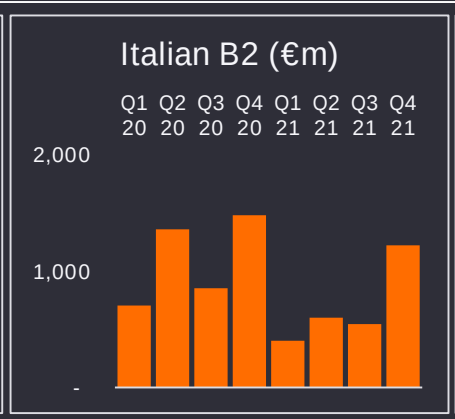
...while others show a more varied pattern with no releases in 2021 and/or an uptick in ECL in the second half of 2021

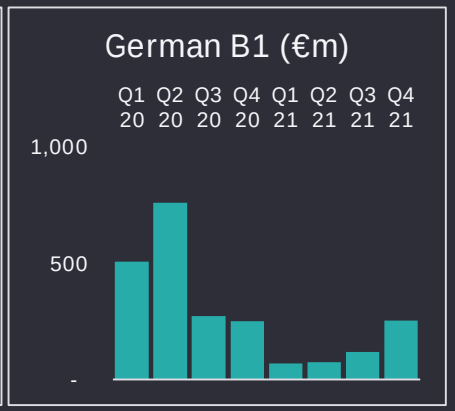
Note: the scales are adjusted to each bank's P/L impacts to emphasize each bank's own P/L dynamics across quarters

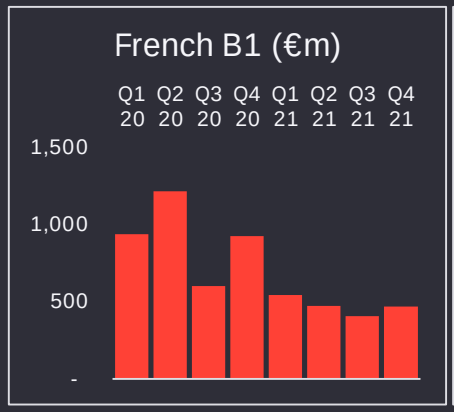


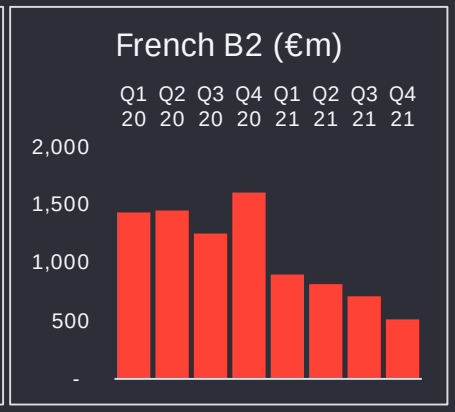


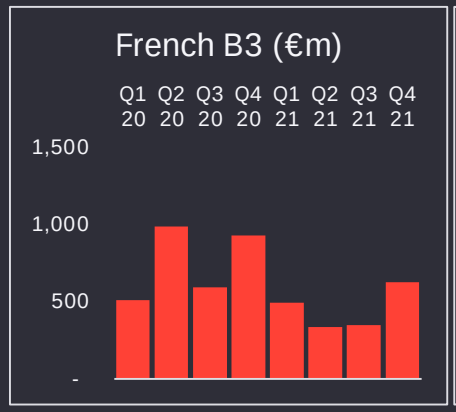


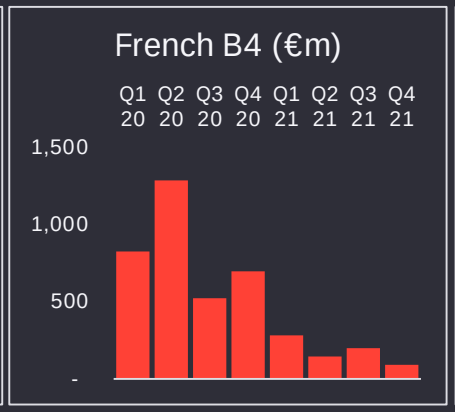


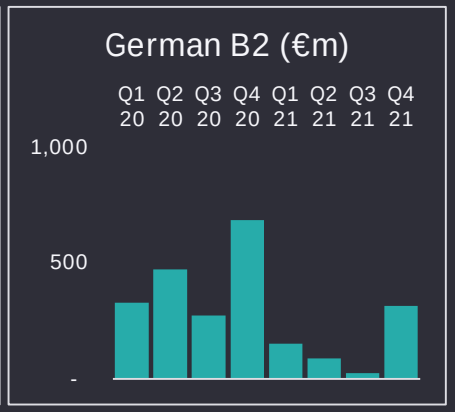






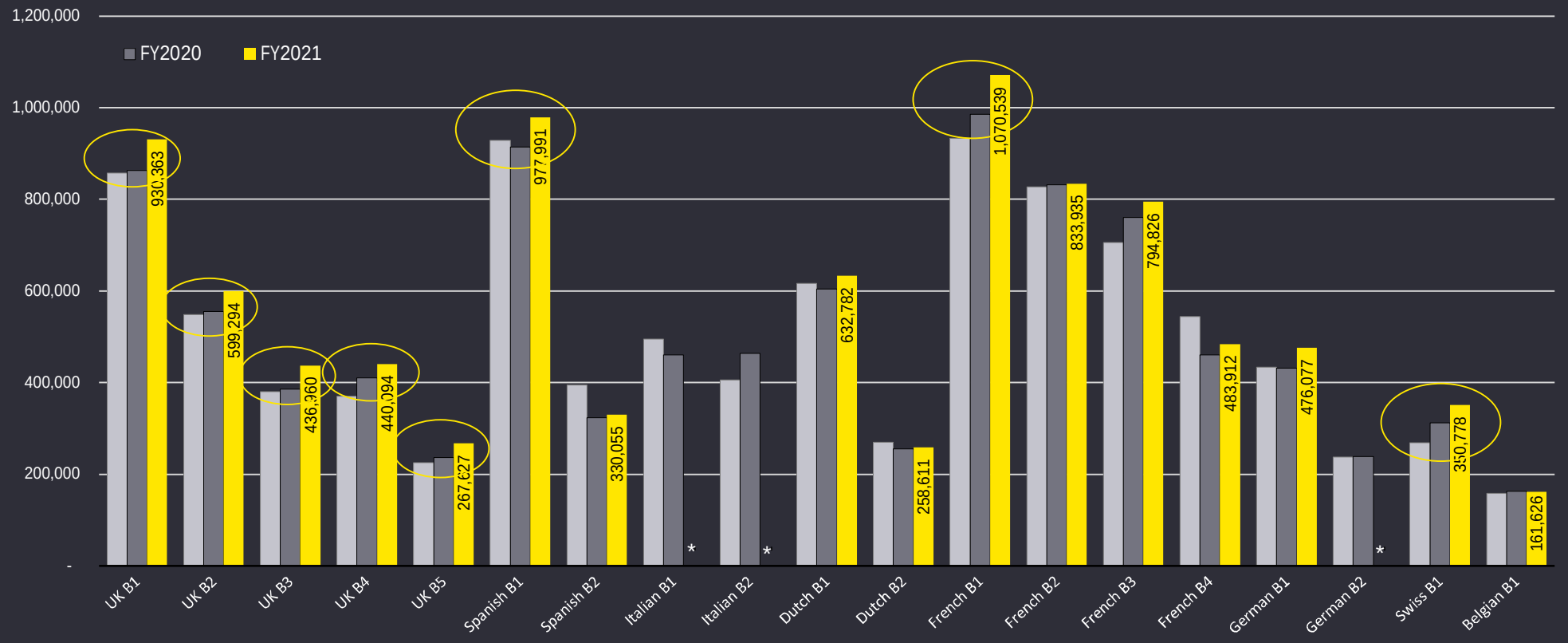






Balances of loans to customers show an increase between 2019 and 2021 above 15% for a number of banks, which also explain some trends on coverage ratios

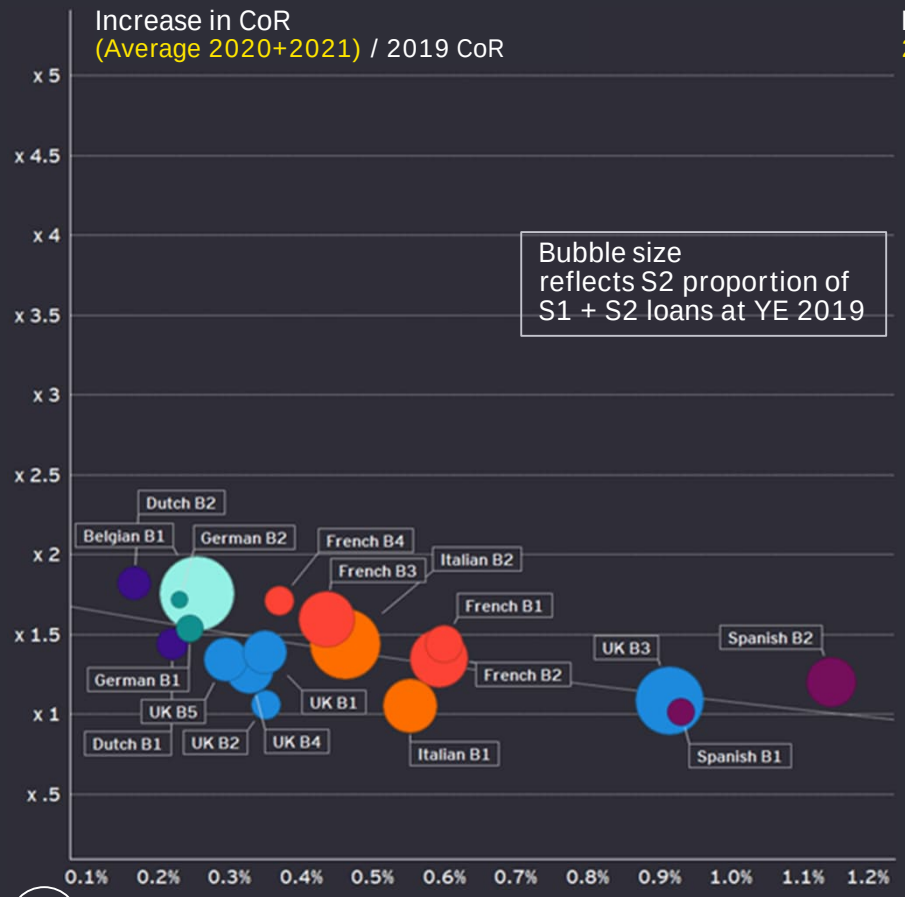
Gross loans to customers (in €m)

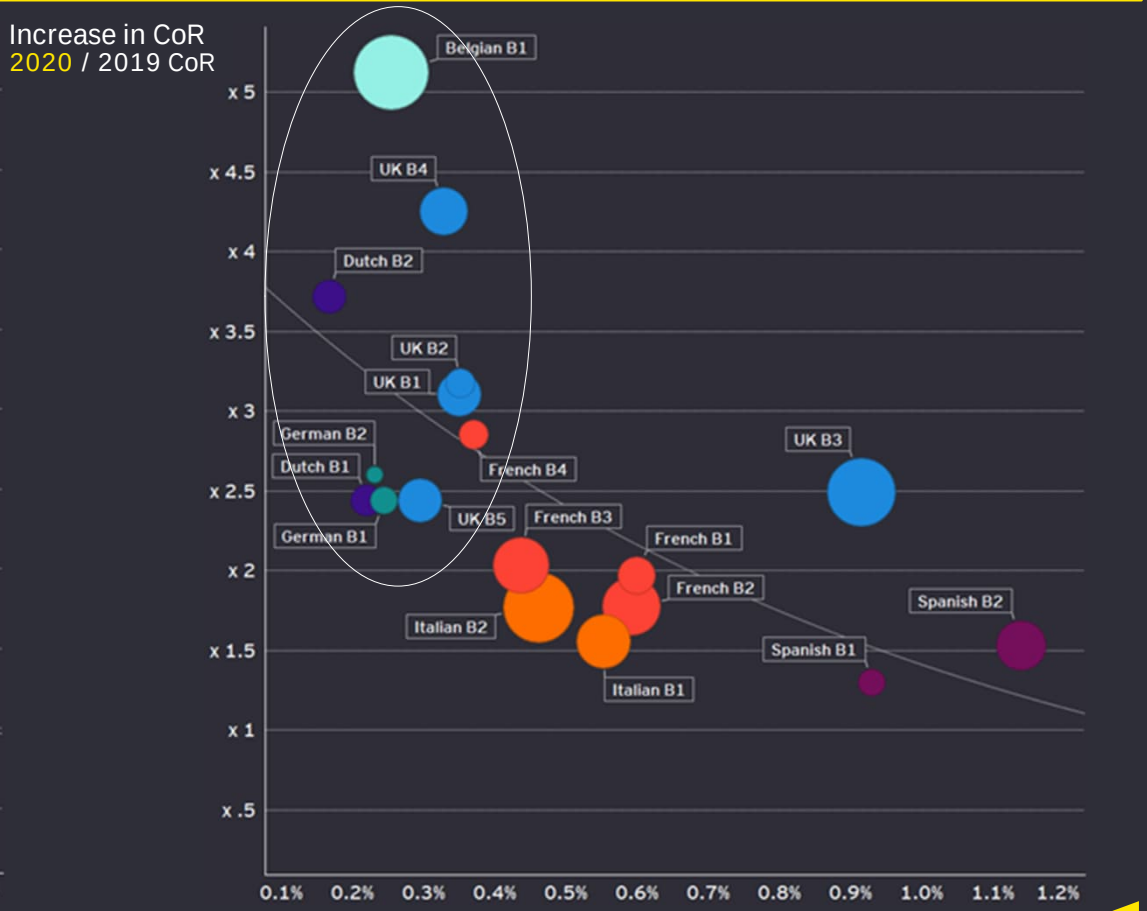


* Data not yet available

Banks with lower S1 + S2 coverage ratios at year-end 2019 had a higher increase in CoR in 2020, but the trend has disappeared at year-end 2021

Correlation between 2019 S1 + S2 coverage ratio and increase in CoR

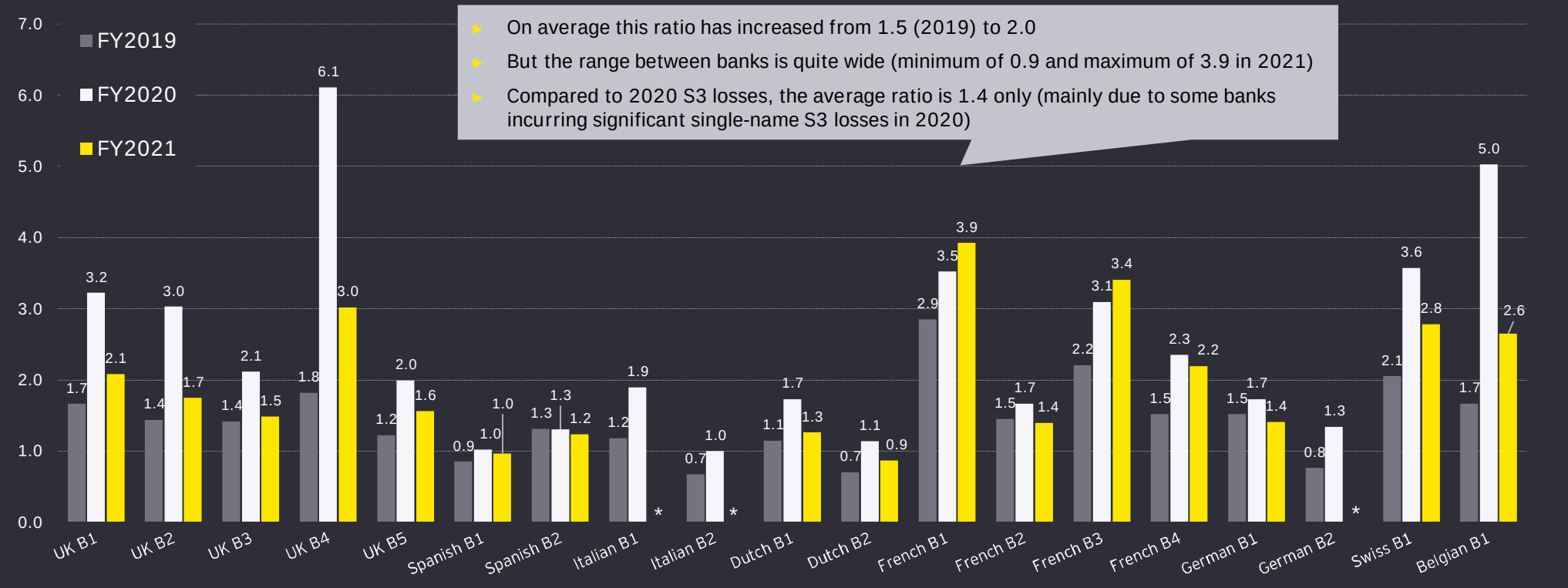




At year-end 2021, the S1 and S2 ECL allowance represents twice the 2019 S3 losses on average (compared to 2.5 at year-end 2020)

How many years of 2019 S3 losses does the S1 and S2 ECL allowance represent?

(S1 + S2) ECL allowance/2019 S3 losses

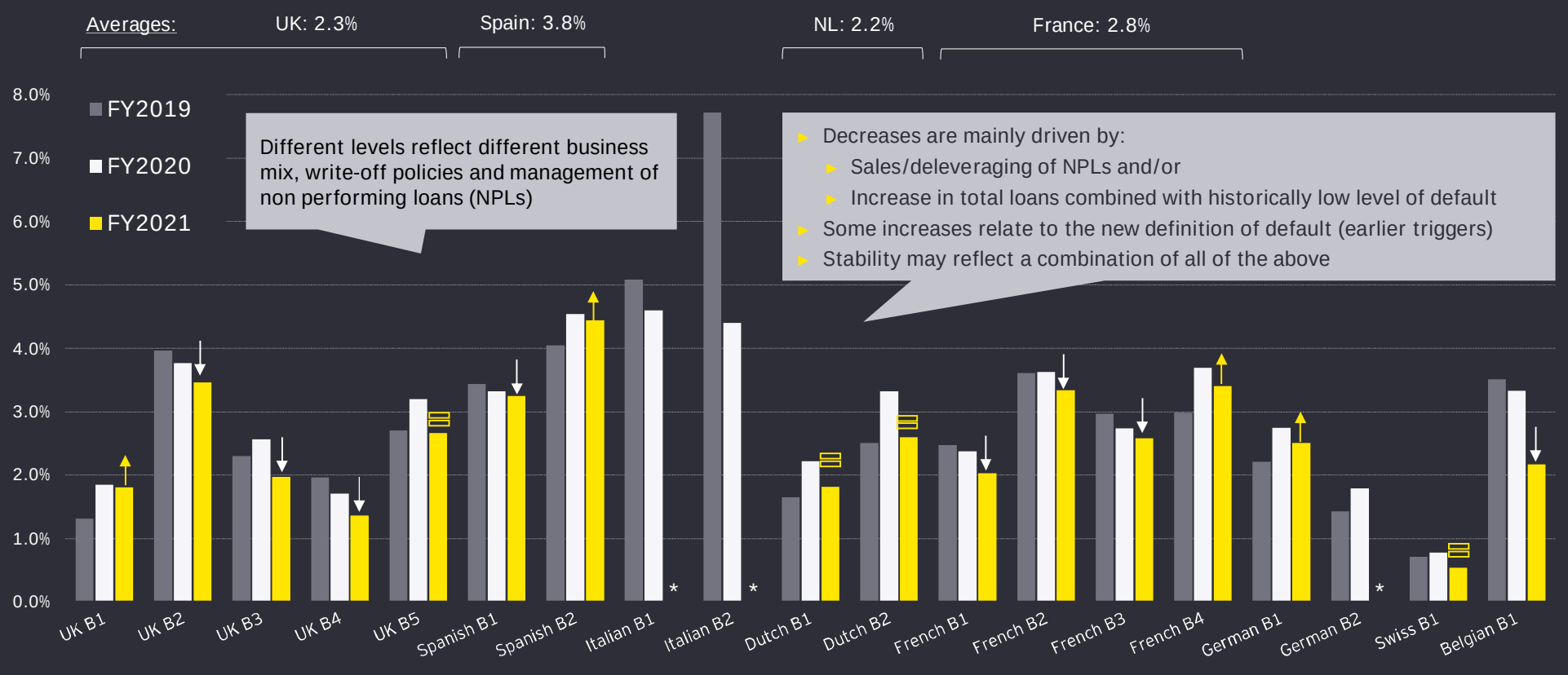


- On average this ratio has increased from 1.5 (2019) to 2.0
- But the range between banks is quite wide (minimum of 0.9 and maximum of 3.9 in 2021)
- Compared to 2020 S3 losses, the average ratio is 1.4 only (mainly due to some banks incurring significant single-name S3 losses in 2020)

* Data not yet available

S3 loans % remain relatively stable reflecting the lag effects in actual credit events due to support measures

Stage 3 loans % of gross loans to customers

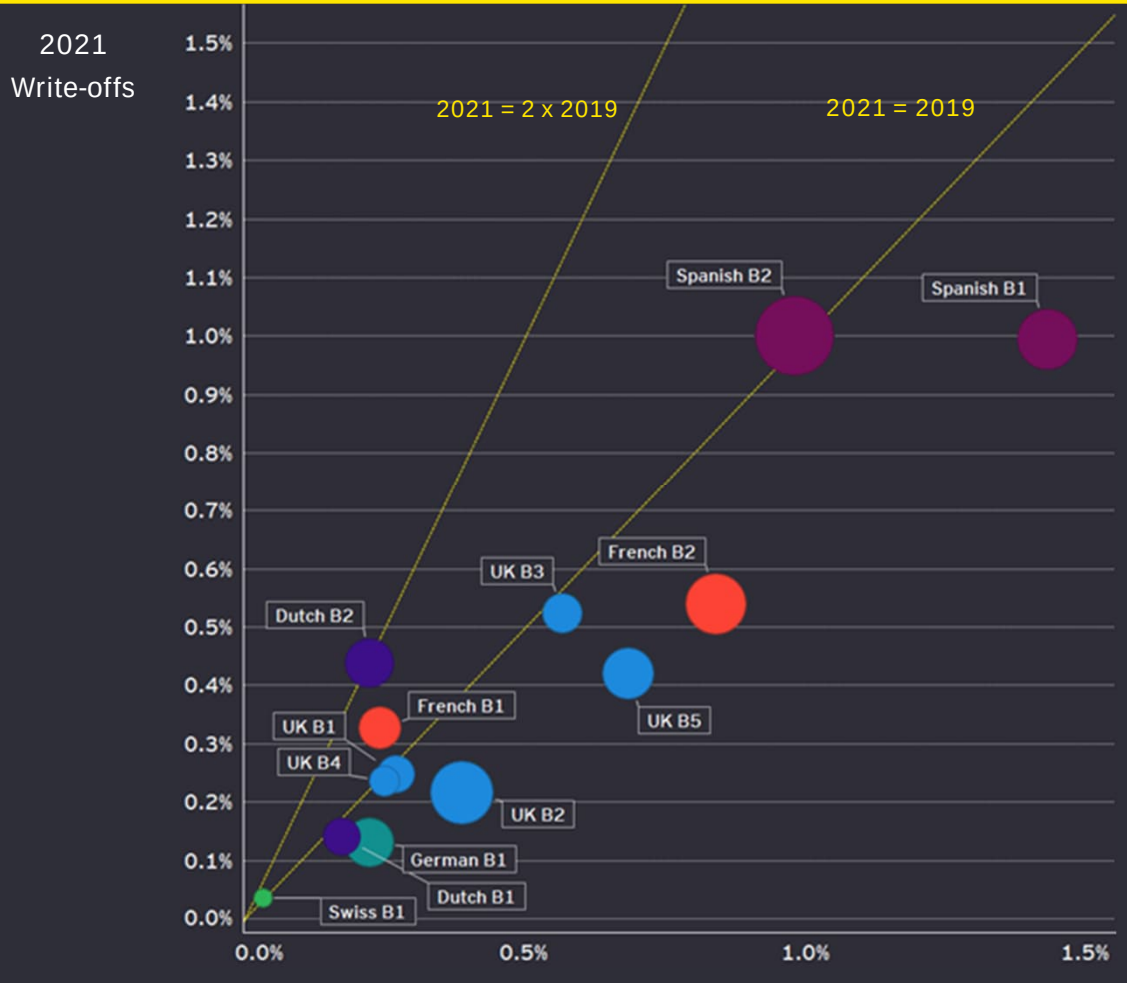


* Data not yet available

Arrows represent movement in S3 loans % comparing 2021 to 2019

Low write-offs levels, like stable S3 %, illustrate the lag effect in actual credit events due to unprecedented level of support measures

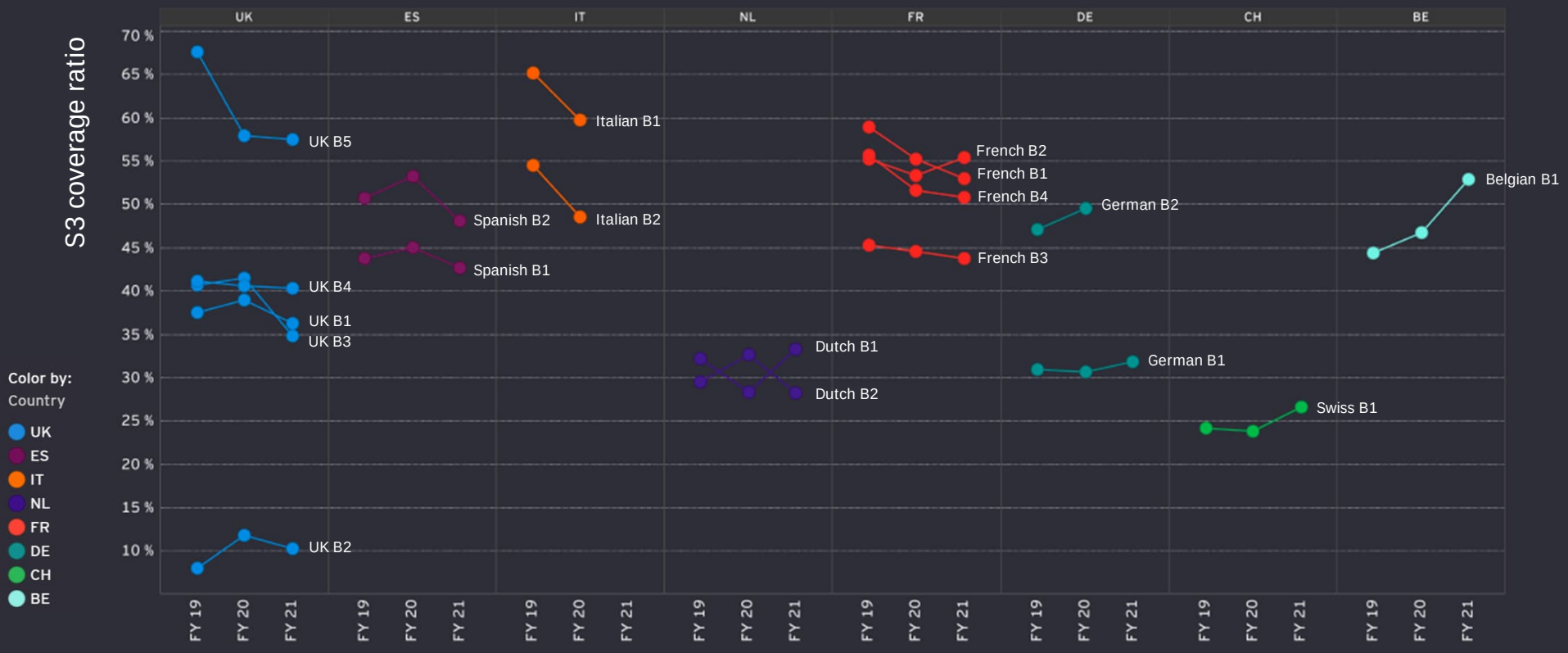
Write-offs/opening balance of gross loans to customers (in %)



Bubble size reflects S3 % at YE 2020

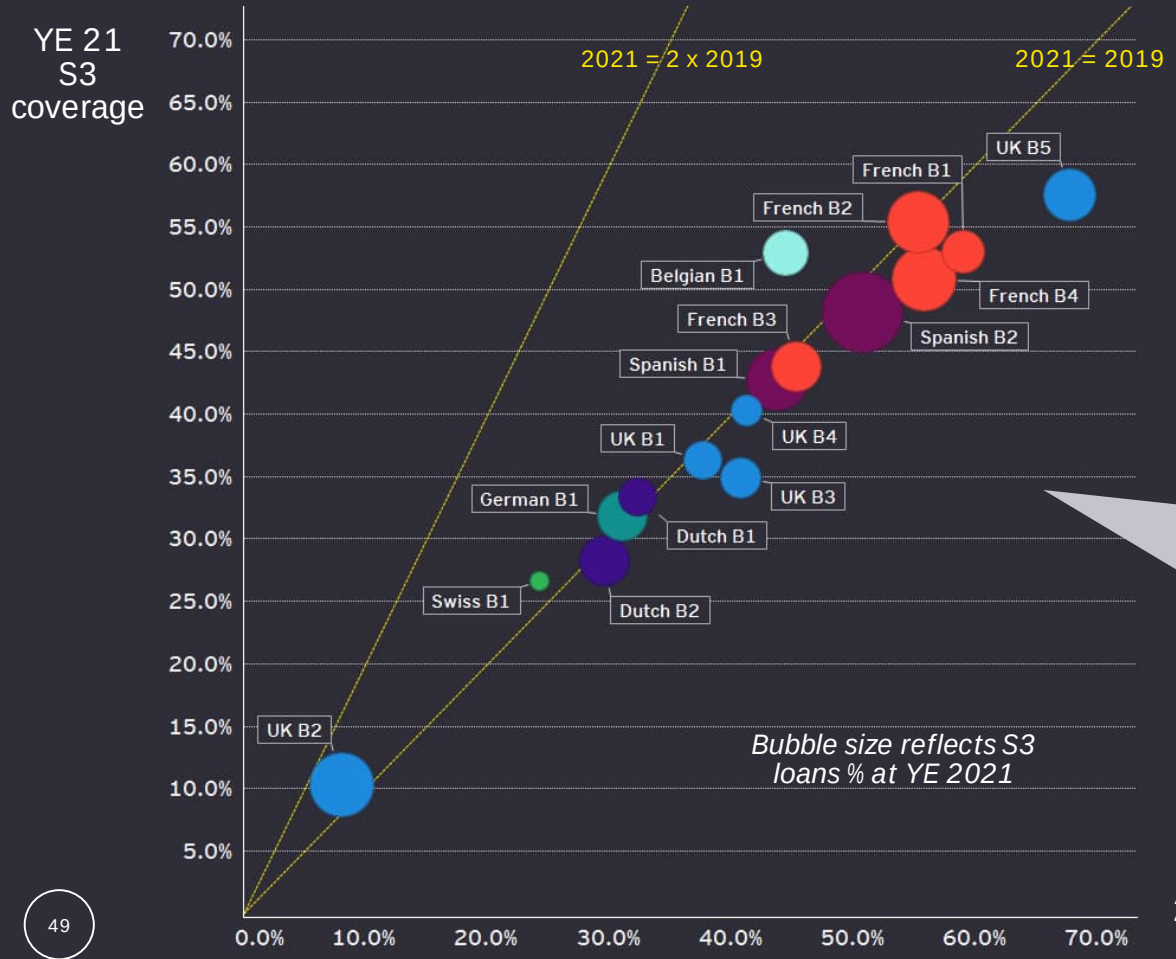
S3 coverage ratios: differences between countries are driven by write-off policies and history/management of non-performing loans

S3 coverage ratio (in %) split by country: year-end 2019 - 2020 – year-end 2021



The S3 coverage ratio is relatively stable at 40% on average
Significant differences remain across banks and countries

S3 coverage ratio (in %)



The S3 coverage ratio has decreased for banks with higher proportions of S3 loans, mainly due to:

- Sales of NPLs
- The change in the definition of default (resulting in an increase in S3 loans of higher quality)

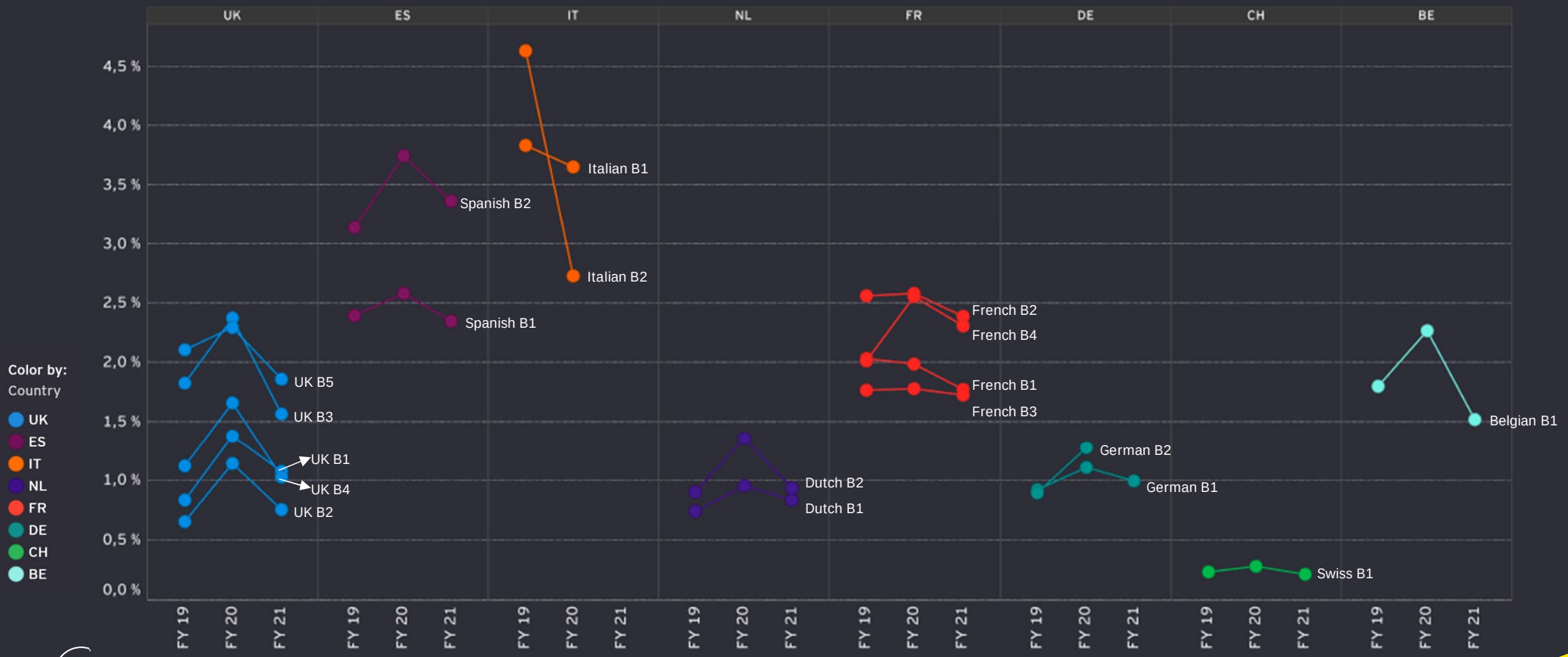
Very different levels of coverage with a clear correlation with the size of S3 loans

High levels of NPLs result in S3 loans of lower quality and attract higher coverage ratios

The business mix also drives the quality of S3 loans (and their coverage ratio)

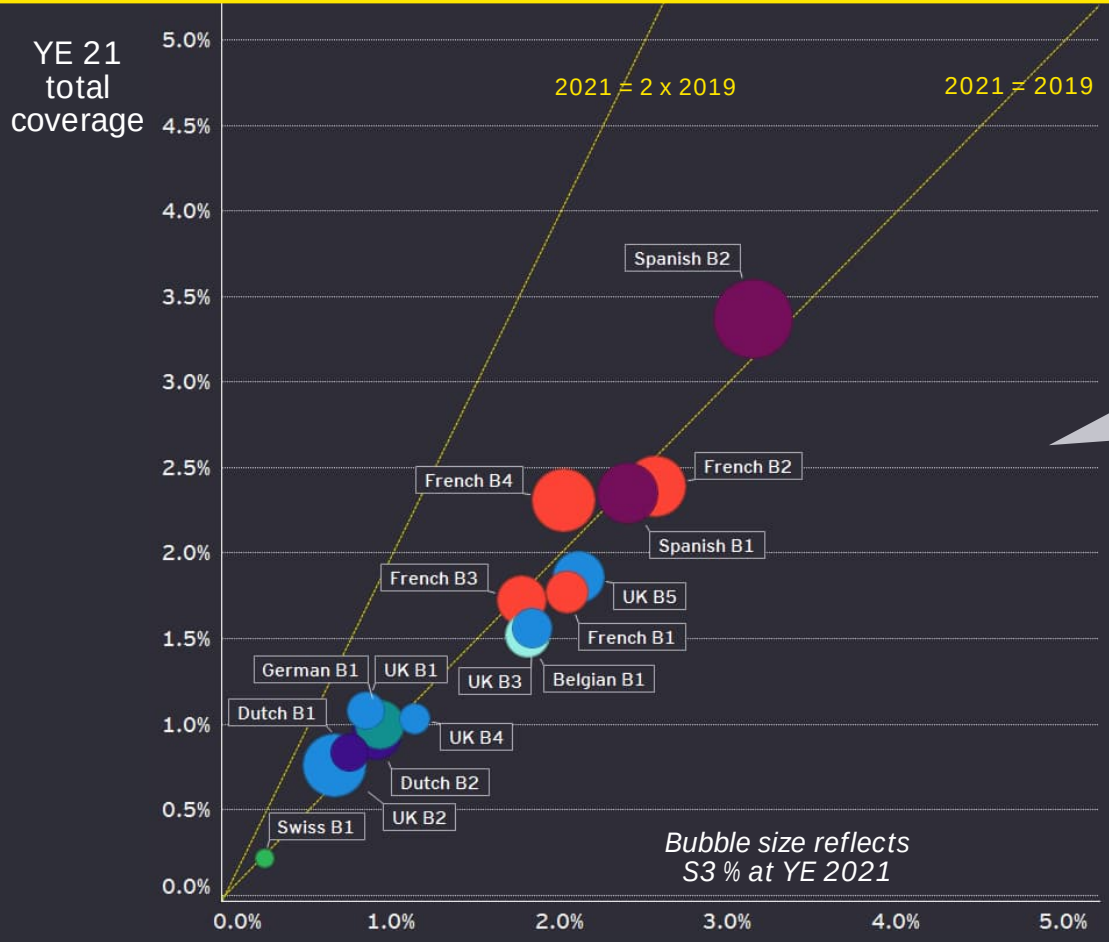
Total coverage ratios show different trends driven by the weight of S3 loans

Total coverage ratio (in %): year-end 2019, 2020 and 2021 split by country



The total coverage ratio is 1,5% on average
Differences in trends are driven by differences in S3 allowance

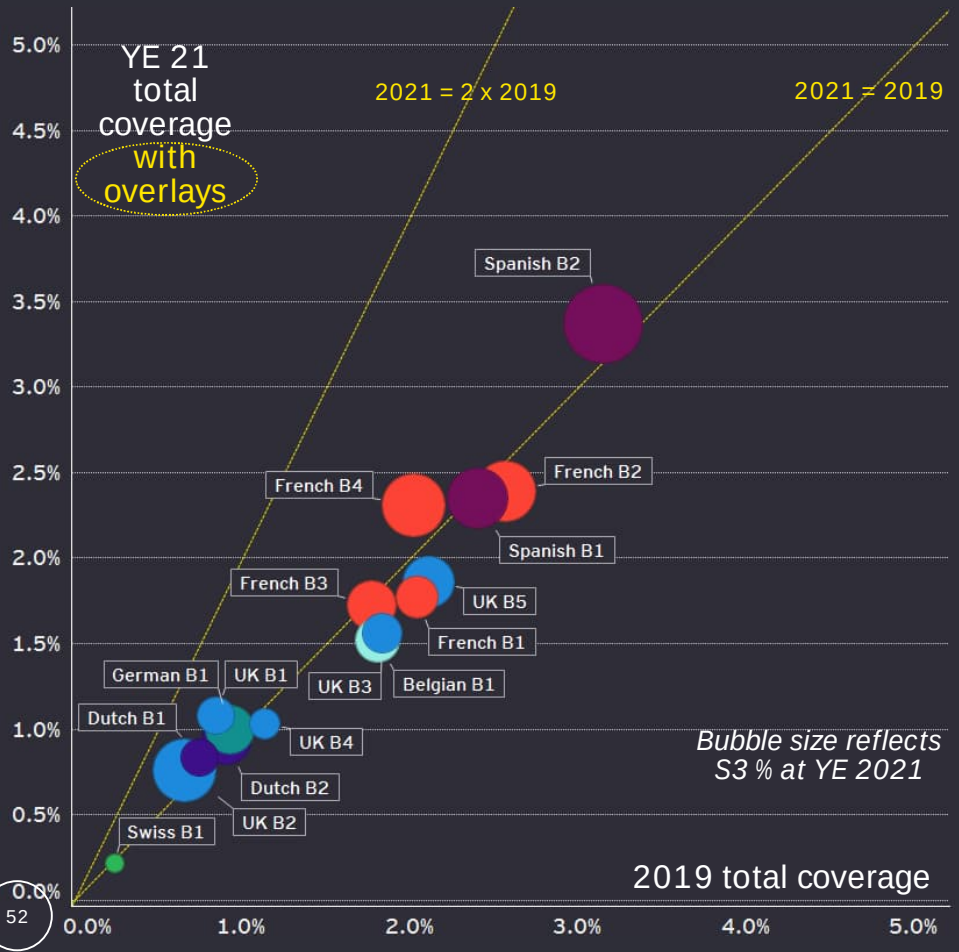
Total coverage ratio (all stages) (in %)

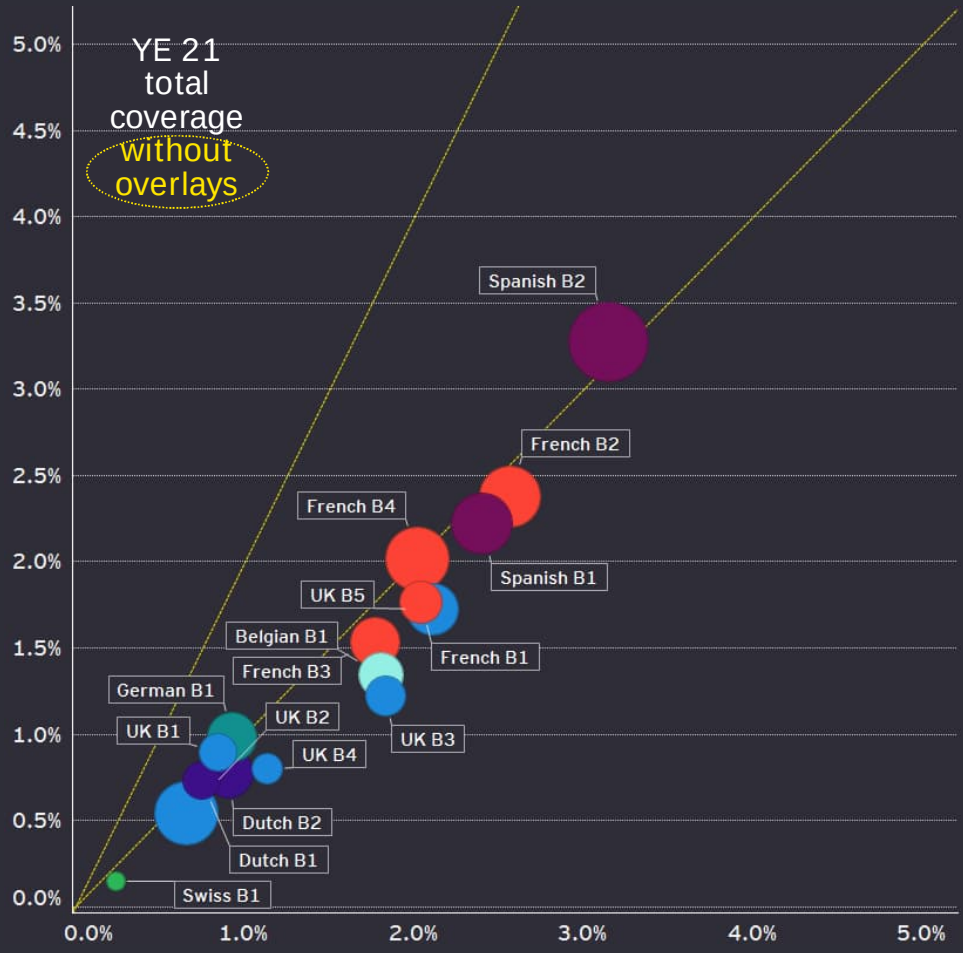


For many banks, the stability of S3 ECL allowance dilutes the effect of the increase in S1 and S2 allowance, resulting in stable total coverage ratio

The impact of overlays is also visible on total coverage ratio

Total coverage ratio (all stages) (in %)





Thank you

- Our next EY Accounting and Regulatory webcast…

June 2022

The next EY webcast will cover:

- Further deep-dive on 2022 challenges due to geopolitical environment and secondary impacts:
  - Overlays
  - Macroeconomic environment
  - Vulnerable sectors
  - Modeling framework considerations

Invitations will be sent in the coming weeks.

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