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Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses

European Banking Authority (EBA)

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List of abbreviations

Abbreviations	Meaning
BCBS	Basel Committee on Banking Supervision
CA	Competent Authority
CRD IV	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EC	European Commission
ECL	Expected Credit Losses
EP	European Parliament
GL	Guidelines
IFRS	International Financial Reporting Standards
PD	Probability of Default

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Introduction

In May 2017, the EBA has issued Final Guidelines (GL) on credit institutions' credit risk management practices and accounting for expected credit losses (ECL)

Introduction

IFRS 9[1], which will replace IAS 39 for the accounting periods beginning on or after 1 January 2018, requires the measurement of impairment loss allowances to be based on an **expected credit losses (ECL)** accounting model, rather than on an incurred loss accounting model. The EBA welcomes to an ECL model, which should result in the earlier recognition of credit losses. However, the application of IFRS 9 also requires the use of judgement in the ECL assessment and measurement process, which could potentially affect the consistent application of IFRS 9 across institutions.

In this context, the BCBS issued in December 2015 supervisory guidance on **credit risk and accounting for expected credit losses**, setting out supervisory expectations for credit institutions related to sound credit risk practices associated with implementing and applying an ECL accounting.

- Following the consultation launched in July 2016, and building on the BCBS guidance, the EBA has published **Final Guidelines (GL) on credit institution's credit risk management practices and accounting for ECL**, with the aim of harmonizing the criteria established by the BCBS and ensuring consistent interpretations and practices according to IFRS 9.
- It is not the objective of these GL to contradict the accounting requirements of IFRS 9, although they may have the effect of restricting the flexibility that IFRS 9 allows.
- These GL would not prevent a credit institution from meeting the impairment requirements of IFRS 9 and the BCBS guidance. Rather, these guidelines should be read as the supervisory approach to support the appropriate application of those standards.

This **Technical Note** includes an analysis of the content of this document. Moreover, Annex 1 contains a list of the main changes introduced by the Final Guidelines when compared to the consultative document.

(1) IFRS 9 – Financial Instruments. IASB, July 2014.

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Executive summary

These GL are divided into four main sections: i) general considerations; ii) 8 principles addressed to credit institutions; iii) guidance specifically addressed to credit institutions applying IFRS 9; and iv) 3 principles for supervisors

Executive summary

Scope of application

- **Credit institutions**[1] (although one section is addressed to only those using IFRS, and other section is addressed to CAs), in relation to their **lending exposures**[2].

Regulatory context

- **Guidance on credit risk and accounting for ECL** (BCBS, Dec.15).
- **CRD IV and CRR**[3] (EP and Council, Jun.14).
- **Relevant technical standards** adopted by the EC[4].

Next steps

- These GL should be implemented at the start of the first accounting period beginning on or after **1 January 2018**.

Main content

General provisions

General considerations on principles of proportionality, symmetry and materiality; and on the use of information.

Principles for credit institutions

8 principles for all credit institutions relating to the provisions for the main elements of credit risk management and accounting for ECL.

1. Management body and senior management
2. Sound ECL methodologies
3. Credit risk rating process and grouping
4. Adequacy of the allowance
5. ECL model validation
6. Experienced credit judgement
7. Common processes, systems, data
8. Disclosure

Guidance specific for credit institutions applying IFRS 9.

1. Loss allowance of 12-month ECL
2. Assessment of significant increases in credit risk
3. Use of practical expedients

Principles for competent authorities (CAs)

3 principles specifically addressed to CAs.

1. Credit risk management
2. ECL measurement
3. Overall capital adequacy

(1) On an individual, sub-consolidated and consolidated basis.
(2) Loans, loan commitments and financial guarantee contracts to which an ECL framework applies.
(3) Regarding internal governance, credit risk, disclosures, SREP, and supervisory measures.
(4) E.g. ITS on forbearance and non-performing exposures.

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General provisions

The EBA GL include general considerations on how credit institutions should apply the principles of proportionality, materiality, and symmetry; and on the use of information by credit institutions, including forward-looking information

General provisions

General principles

- Credit institutions should apply these GL considering the principles of **proportionality**, **materiality** and **symmetry**.

Proportionality

- Credit institutions should comply with these GL in a manner that is appropriate to their **size and internal organisation**; the nature, scope and complexity of their **activities and portfolios**; and generally, **all other relevant facts and circumstances** of the credit institution (or of the group, if any, to which it belongs).

Materiality

- They should also consider the principle of materiality, although it should **not result** in individual exposures or portfolios being considered **immaterial** if, cumulatively, they represent a **material exposure**. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement.

Symmetry

- The **timely recognition** of credit deterioration and allowances **should not be delayed**, without prejudice to the fact that ECL accounting frameworks are symmetrical in the way that subsequent changes in the credit risk profile of a debtor should be considered in the measurement of the allowances.

Reasonable and supportable information

- Credit institutions should consider a **wide range of information** when applying ECL accounting models, including information about **past events**, **current conditions** and **forecasts of future economic conditions**.
- They should also use their **experienced credit judgement** in determining the range of relevant information for the assessment of credit risk and measurement of ECL of the particular lending exposure.

Forward looking information

- Credit institutions should consider forward-looking information, including **macroeconomic factors**. They should apply experienced credit judgement in the consideration of **future scenarios** and take into account the potential consequence of events and the resulting **impact** on the measurement of ECL.
- They should be able to **demonstrate** how they have considered **relevant, reasonable and supportable information** in the ECL assessment and measurement process.

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Principles on credit risk management practices and accounting ECL

In the second section, the GL set out 8 principles addressed to all credit institutions. Principle 1 defines the responsibilities of the management body and senior management for ensuring that credit institutions have in place appropriate credit risk management practices

Principle 1: Management body and senior management responsibilities

Definition of Principle 1

- The **management body and senior management** are responsible for ensuring that the credit institution has **appropriate credit risk management practices**, including an effective internal control system, to consistently determine adequate allowances[1].

Role of the management body

- The management body should be responsible for **approving and regularly reviewing** a credit institution's **credit risk management strategy** and the main policies and processes for identifying, measuring, evaluating, monitoring, reporting and mitigating credit risk consistent with the approved risk appetite. To fulfil these responsibilities, the management body should **instruct senior management** to:
  - Develop and maintain appropriate **processes** to determine **appropriate allowances**.
  - Establish and implement an effective **internal control system** for credit risk assessment and measurement; and **report periodically their results** (including estimates of its ECL allowances).
  - Establish, implement and update suitable policies and procedures to **communicate** the credit risk assessment and measurement process internally all relevant staff.

Internal control system

- An effective internal control system for credit risk assessment and measurement should include:
  - Measures to comply with applicable **laws, regulations, internal policies and procedures**.
  - Measures to provide **oversight of the integrity of information** used and reasonably ensure that the allowances reflected in the credit institution's financial statements and reports submitted to the CA are subject to the applicable accounting framework and relevant supervisory requirements.
  - Well-defined **credit risk assessment and measurement processes** that are **independent** from (while taking appropriate account of) the lending function (e.g. *inter alia* an effective credit risk rating system, an effective model validation process, etc.).
  - An **internal audit function** that **independently** evaluates the effectiveness of the credit risk assessment and measurement systems, and that makes recommendations on addressing any weaknesses.

(1) In accordance with the credit institution's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

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According to Principle 2, credit institutions should establish sound methodologies, procedures and controls for assessing and measuring credit risk

Principle 2: Sound ECL Methodologies (1/2)

Definition of Principle 2

- Credit institutions should adopt, document and adhere to policies which include **sound methodologies, procedures and controls for assessing and measuring credit risk** on all lending exposures. The measurement of allowances should build upon those methodologies.

Processes and methodologies

- The credit risk assessment and measurement process should provide the relevant information for **senior management to make its experienced judgements** about the credit risk of lending exposures, and the **related estimation of ECL**.
- **Common processes, systems and tools** should be used to determine whether credit should be granted, monitor credit risk, and measure allowances for accounting and capital purposes.
- Credit institutions should establish **adequate processes and systems** to appropriately identify, measure, evaluate, monitor, report and mitigate the **level of credit risk** which should be evaluated and, if necessary, modified to collect and analyse relevant information.
- Credit institutions should adopt and adhere to **written policies and procedures** detailing the credit risk systems and controls used in its credit risk methodologies and the separate roles and responsibilities of the credit institution's management body and senior management.
- **Sound methodologies** for assessing credit risk and measuring the level of allowances should, among others, include a robust process to equip credit institutions with the ability to know the level, nature and drivers of credit risk, the criteria to consider the impact of forward-looking information[1], etc.
- The **credit risk identification process** should ensure that factors that impact changes in credit risk and estimates of ECL are properly identified on a regular basis.
  - Regarding the **factors related to the borrower**, a credit institution should (depending on the type of exposure) consider the borrower's sources of recurring income available to meet the scheduled payments, overall leverage level, willingness to meet the obligations, etc.
  - If there are factors that have the potential to affect the credit institution's ability to **recover amounts due**, it should consider those factors relating to the business model and current and forecasted macroeconomic conditions (e.g. regulatory requirements, institution's overall volume of credit, etc.).

(1) Annex 2 details the requirements that these methodologies should meet to be considered sound.

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Principles on credit risk management practices and accounting ECL

According to Principle 2, credit institutions should establish sound methodologies, procedures and controls for assessing and measuring credit risk

Principle 2: Sound ECL Methodologies (2/2)

Processes and methodologies

- Sound credit risk methodologies should consider **different potential scenarios** and should not rely purely on subjective, biased or overly optimistic considerations. Credit institutions should **develop and document its process to generate relevant scenarios** to be used in the estimation of ECL (including how ECL estimates would alter with changes in scenarios, the process for determining the time horizon, backtesting, etc.) considering all reasonable and supportable information that is relevant.
- **Senior management** should be able to demonstrate that it understands and appropriately considers **inherent risks when pricing** lending exposures.
  - Credit institutions should take particular care of certain fact **patterns** potentially **indicative of inadequate estimates of ECL** (e.g. granting of credit to borrowers based on fragile income streams or with limited verification of borrower income sources, flexible repayment schedules, etc.).

Renegotiations/ modifications

- Credit institutions' **accounting policies** should address, and their allowance methodology should include, criteria for renegotiations/modifications of lending exposures due to financial difficulties or for other reasons, considering also the specific definitions of forbearance[1]. In particular, credit institutions should take into account the following specific criteria:
  - The allowance level continues to reflect the collectability of the substance of the modified exposure.
  - Renegotiations/modifications should not automatically lead to the conclusion that there has been an immediate decrease in the credit risk of the exposure.
  - The collection of loan principal is reasonably assured when repayment performance takes the form of interest payments alone.
  - The methodologies should also call upon the lending staff to promptly notify the institution's accounting function when exposures are renegotiated or modified to ensure appropriate accounting for the change.
- Regarding **purchased or originated credit-impaired exposures**, they should consider the following:
  - The methodology should enable appropriate identification and accounting.
  - The cash flow estimates for these exposures should be reviewed each reporting period and updated as necessary. Such updates should be properly documented, and approved by senior management.

(1) Established in Part 2 of Annex V of Commission Implementing Regulation (EU) 680/2014.

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Principles on credit risk management practices and accounting ECL

Principle 3 states that all credit institutions should have in place a credit risk rating process to group lending exposures considering a basis of shared credit risk characteristics. Moreover, it specifies when temporary adjustments should be used

Principle 3: Credit risk rating process and grouping

Definition of Principle 3

- A credit institution should have a **credit risk rating process** in place to appropriately **group lending exposures** on the basis of shared credit risk characteristics**.**

Credit risk rating process

- Credit institutions should:
  - Establish comprehensive procedures and information systems to **monitor the quality** of their lending exposures. These include an **effective credit risk rating process** that captures the varying level, nature and drivers of credit risk[1], and which should include an **independent review function**.
  - Consider a number of **criteria** when assigning the credit risk grade upon initial recognition of a lending exposure (e.g. product type, collateral, borrower characteristics, etc.) and when changing existing grades assigned (e.g. changes in industry outlook, changes in economic forecasts, etc.).
  - Describe the **elements of their credit risk rating system**, clearly defining each **credit risk grade** and designating the staff responsible for the design, implementation, operation and performance of the system as well as those responsible for periodic testing and validation.
  - **Review credit risk grades** whenever new information is received or a expectation of credit risk has changed. Moreover, they should be receive a **periodic formal review**.

Grouping of exposures

- Credit institutions should **group exposures with shared credit risk characteristics** in a way that is sufficiently granular to be able to assess changes in credit risk and thus the impact on the estimate of ECL.
- A credit institution's **methodology** for grouping exposures to assess credit risk should be **documented** and subject to **review** and **internal approval by senior management**. In grouping exposures, credit institutions should consider the effect on the group's credit risk of changes in forward-looking information.

Use of temporary adjustments

- Credit institutions should use **temporary adjustments** to an allowance only as an **interim solution** or when lending exposures within a group react to factors or events differently than initially expected.
- Temporary adjustments should be directionally **consistent with forward-looking forecasts**, supported by appropriate **documentation**, and subject to appropriate **governance processes**.

(1) The credit risk rating system should capture all lending exposures and not only those that may have experienced significant increases in credit risk, have incurred losses or are otherwise credit impaired.

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Principles on credit risk management practices and accounting ECL

According to Principle 4, the aggregate amount of allowances should be adequate and consistent with the accounting framework, regardless of whether they are estimated using an individual or a collective approach

Principle 4 : Adequacy of the allowance

Definition of Principle 4

- A credit institution's **aggregate amount of allowances**, regardless of whether allowances are determined on a collective or an individual basis, should be **adequate** and consistent with the objectives of the applicable accounting framework.

Information for allowances determination

- When assessing the adequacy of the allowances credit institutions should consider **relevant factors and expectations** that may affect the remaining cash flows over the life of a single/group of lending exposures.
- Credit institutions should consider information which goes **beyond historical and current data**, and take into account reasonable and supportable **forward-looking information**, including macroeconomic factors.

Individual vs. collective assessment

- Depending on the ability to incorporate **forward-looking information** into the ECL estimate, credit institutions may use **individual or collective** assessment approaches.
  - If an individual assessment of exposures do not adequately consider forward-looking information, institution should group lending exposures with shared credit risk characteristics.
- The ECL assessment approach used should be the **most appropriate** and should be **aligned with how the credit institution manages** the lending exposure (collective assessment is often used for large groups of homogeneous lending exposures with shared credit risk characteristics, such as retail portfolios; whereas individual assessments are often conducted for significant exposures).
- Regardless of the assessment approach used, allowances should be **consistent with the relevant accounting requirements** and neither result in materially different allowance amounts nor result in delayed recognition of ECL.
- When applying either an individual assessment or a collective assessment, the credit institution's **documentation** should clearly demonstrate how **forward-looking information**, including macroeconomic factors, has been reflected in the assessment.

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Principles on credit risk management practices and accounting ECL

Principle 5 establishes that credit institutions should develop policies and procedures to validate the ECL models. In this regard, the EBA includes a non-exhaustive list of the elements that a sound model validation framework should include

Principle 5 : ECL model validation

Definition of Principle 5

- A credit institution should have **policies and procedures** in place to appropriately **validate models** used to measure ECL.

ECL models

- Credit institutions may use in the ECL assessment and measurement process **models and assumption-based estimates** for risk identification and measurement, for accounting purposes, stress testing, and capital allocation.

Model validation

- Credit institutions should have robust policies and procedures in place to appropriately validate the **accuracy and consistency of the models** used to assess the credit risk and measure ECL, including their model-based credit risk rating systems and the estimation of all relevant risk components. Such policies and procedures should appropriately include the role of **professional judgement**.
- Model validation should be conducted when ECL models are **initially developed** and when **significant changes** are made, and should ensure that they are suitable for their proposed usage on an ongoing basis.
- A sound **model validation framework** should include, but not be limited to, the following elements:
  - Clear roles and responsibilities with adequate independence and competence. In this regard, model validation should be performed **independently** of the model development process and by staff with the necessary **experience and expertise**. Where a credit institution has **outsourced** its validation function, it remains responsible for the effectiveness of model validation
  - A **systematic process of evaluating** the model's robustness, consistency and accuracy as well as its continued relevance to the underlying individual lending exposure or portfolio. The scope for validation should include a review of model inputs, model design, and model outputs.
  - Comprehensive **documentation** of the model validation framework and process[1] (e.g. validation procedures performed, any changes in validation methodology and tools, the range of data used, etc.).
  - A **review** of the model validation process by **independent parties** (internal or external) to evaluate the effectiveness and the independence of the model validation process. The findings of the review should be reported to the appropriate level of authority (e.g. senior management, audit committee).

(1) Credit institutions should ensure that the documentation is regularly reviewed and updated.

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Principles on credit risk management practices and accounting ECL

Principle 6 establishes that credit institutions should use their experienced credit judgement when considering forward-looking information

Principle 6: Experienced credit judgement

Definition of Principle 6

- A credit institution's use of **experienced credit judgement**, especially in the consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is **essential** to the assessment of credit risk and measurement of ECL.

Use of forward-looking information

- Consideration of **forward-looking information should not be avoided** on the basis that a credit institution considers the cost of incorporating such forward-looking information to be very high or unnecessary or because there is uncertainty in formulating forward-looking scenarios[1].

Experienced credit judgement

- Credit institutions should be able to demonstrate that the forward-looking information factored into the ECL estimation process has a **link to the credit risk drivers** for particular exposures or portfolios. In this regard, they should use their **experienced credit judgement**[2] in establishing an appropriate level for the individual or collective allowance.
- When a forward-looking factor that has been identified as relevant is not incorporated into the individual or collective assessment, **temporary adjustments** may be necessary.
- Macroeconomic forecasts and other information should be applied **consistently across portfolios** if the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way.
- Credit institutions should **exercise care** when determining the **level of ECL allowances** to be recognised for accounting purposes to ensure that the resulting estimates are appropriate (i.e. consistent with neutrality and neither understated nor overstated).
- Additionally, credit institutions should avail themselves of a **wide range of information** from the **credit risk management process**, including that of a forward-looking nature for risk management and capital adequacy purposes, in developing their estimate of ECL.

(1) Unless the additional cost and operational burden to be introduced do not contribute to a high-quality implementation of an ECL accounting framework.
(2) Given that it may not be possible to demonstrate a strong link in formal statistical terms between certain types of information and the credit risk drivers.

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Principles on credit risk management practices and accounting ECL

Principle 7 determines that credit institutions should use common processes, systems, tools and data to assess credit risk, measure ECL for accounting purposes and determine expected losses for capital adequacy purposes

Principle 7: Common processes, systems, tools and data

Definition of Principle 7

- Credit institutions should have a sound credit risk assessment and measurement process that provides them with a strong basis for **common processes**, **systems**, **tools and data** to assess credit risk and to account for ECL.

Processes, systems, tools and data

- To the maximum extent possible, credit institutions should use **common processes, systems, tools and data** to assess credit risk, measure ECL for accounting purposes and determine expected losses for capital adequacy purposes.
- These common processes, systems, tools and data could include *inter alia* the following: credit risk rating systems, estimated PDs (subject to appropriate adjustments), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, market segment, geographical location, etc.

Review of credit risk practices

- Credit risk practices should be **reviewed periodically** to ensure that relevant data available throughout a credit institution's organisation are captured and that systems are updated as the credit institution's underwriting or business practices change or evolve over time.
- A **feedback loop** should be established to ensure that information on estimates of ECL, changes in the credit risk and actual losses experienced on lending exposures is **shared among credit risk experts**, **accounting and regulatory reporting staff**, and in particular with the **loan underwriting staff**.

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Principles on credit risk management practices and accounting ECL

Principle 8 includes provisions regarding the disclosure of information by credit institutions. Among other things, the EBA establishes that senior management should define the appropriate level of aggregation of data disclosed, and that disclosure policies should be reviewed regularly

Principle 8: Disclosure

Definition of Principle 8

- A credit institution's **public disclosures** should promote **transparency and comparability** by providing timely, relevant and decision-useful information.

Information to be disclosed

- Credit institutions should provide **information that is relevant and comparable** so that users can make timely, informed decisions and are able to evaluate the stewardship of management body and senior management.
- The senior management should apply **judgement** to determine the **appropriate level of aggregation and disaggregation** of data disclosed.
- **Quantitative and qualitative disclosures** when taken as a whole should communicate to users the main assumptions/inputs used to develop ECL estimates. In this regard, disclosures should highlight:
  - Policies and definitions that are integral to the estimation of ECL.
  - Factors that cause changes in ECL estimates.
  - The manner in which senior management's experienced credit judgement has been incorporated.
- Regarding **qualitative disclosures**, credit institutions should provide how **forward-looking information**, including macroeconomic factors, has been incorporated into the ECL estimation process, in particular when the assessment has been carried out on a particular basis.
- Disclosures regarding the basis for **grouping lending exposures** should include information of how senior management satisfies itself that lending exposures are appropriately grouped.
- To improve the quality and meaningfulness of information disclosed for ECL estimates, they should provide an **explanation of significant changes** to the estimation of ECL from period to period.

Review of disclosure policies

- The **management body** should **regularly review its disclosure policies** to ensure that the information disclosed continues to be relevant to the credit institution's risk profile, product concentrations, industry norms and current market conditions.

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Guidelines specific to credit institutions applying IFRS 9

In the third section, the EBA includes guidance specific to credit institutions applying IFRS 9. Among others, the EBA provides guidance on the loss allowance equal to 12-month ECL

Loss allowance at an amount equal to 12-month ECL

Allowance of 12-month ECL

- Credit institutions should **measure ECL for all lending exposures**[1].
  - They should adopt an **active approach** to assessing and measuring 12-month ECL.
  - Credit institutions must note that under IFRS 9 an amount equal to the 12-month ECL it is the expected **cash shortfalls over the life** of the lending exposure or group of lending exposures due to **loss events that could occur in the next 12 months**.
  - A **nil allowance** should be **rare** because ECL estimates are a probability-weighted amount that should reflect the possibility that a credit loss will occur (although it could occur for fully collateralised loans).
- When adopting a **definition of default for accounting purposes**, credit institutions should be guided by the definition used for regulatory purposes provided in the **CRR**, which includes a qualitative criterion (unlikeliness to pay) and an objective indicator (more than 90 days past due on any material obligation).
- In formulating the estimate of the amount equal to 12-month ECL, credit institutions should consider reasonable and supportable information, especially **forward-looking information** (including macroeconomic factors). Even though under IFRS 9 an entity does not need to undertake an exhaustive search for information, credit institutions should actively incorporate information that may affect the estimate of ECL.
- Where a credit institution originates **high-credit-risk exposures** and their allowances are initially measured at 12-month ECL, it should **monitor these exposures closely** for significant increases in credit risk.
- Even if an **increase in credit risk** is not judged to be significant, a credit institution should adjust its estimate of 12-month ECL to appropriately reflect changes in credit risk that have taken place.
- Where information indicates that further or different segmentation within a group of lending exposures is required, the group should be split into **subgroups** and the measurement of the amount equal to **12-month ECL should be updated** separately for **each subgroup**.

(1) According to IFRS 9, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month ECL if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition.

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Guidelines specific to credit institutions applying IFRS 9

Under IFRS 9, entities should estimate lifetime ECLs for all financial instruments for which there have been significant increases in credit risk. In this regard, the EBA specifies several aspects in relation to the assessment of significant increases in credit risk

Assessment of significant increases in credit risk (1/3)

Governance, systems and controls

- Credit institutions should have in place **sound governance, systems and controls** to consider whether an exposure has suffered a **significant increase in credit risk**. Unless already established, credit institutions should implement systems capable of systematically assessing the **large amounts of information**.
- This should include, in particular, putting in place processes to ensure that **forecasts of economic conditions** in different jurisdictions and economic sectors are reviewed and approved by a credit institution's **senior management**, and that the process, controls and economic assumptions around developing forecasts and linking these to expectations of credit loss are **consistent** across the group[1].

Information to be used

- The range of information that will need to be considered is wide. A critical feature is the required consideration of all reasonable and supportable **forward-looking information** that is available without undue cost and effort, in addition to information about current conditions and historical data.
- In order to recognise allowances on a timely basis in line with the IFRS 9 requirements, credit institutions should: i) **assemble data and forward projections** for the key drivers of credit risk and, ii) be able to **quantify the credit risk** in each of their lending exposures based on the projections.
- Credit institutions' analyses should consider the fact that the determinants of credit losses begin to deteriorate a considerable time before any evidence of delinquency appears in the lending exposures. Thus, they should also consider the **linkages between macroeconomic factors and borrower attributes** to the level of credit risk in a portfolio based on reasonable and supportable information.
  - To that end, credit institutions should start with a detailed **analysis of historical patterns and current trends**[2], which would allow for identification of the most relevant credit risk drivers.
  - **Experienced credit judgement** should facilitate the incorporation of current and forecasted conditions likely to affect those risk drivers, the expected cash shortfalls and therefore loss expectations.

(1) The need for consistency should not be interpreted as a requirement that the practice be identical across a group, although differences should be well documented and justified.
(2) Credit institutions should perform analyses of this kind not only in the context of portfolios of individually small credits, but also for large, individually managed lending exposures.

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Guidelines specific to credit institutions applying IFRS 9

In particular, the EBA provides guidance with regard to the systems and controls for the assessment of significant increases in credit risk, the information to be used in this assessment, and the policy that credit institutions should have on what constitutes a 'significant increase'

Assessment of significant increases in credit risk (2/3)

Policy on 'significant Increase'

- Credit institutions should have a clear **policy with well developed criteria** on what constitutes a **'significant increase**' in credit risk for different types of lending exposures. Such criteria should be **disclosed**[1]. For these purposes, significant should neither be equated with statistical significance (i.e. only quantitative analysis), nor be judged in terms of the extent of impact on a credit institution's primary financial statements.
- In developing their approach to determining a 'significant increase', credit institutions should consider each of the **16 classes of indicators in IFRS 9**[2] (insofar as they are relevant to the financial instrument assessed); and also some **other indicators** specified in the GL based on their relevance (some of these indicators are related to the environment in which a credit institutions or the borrower operates –e.g. deterioration of the macroeconomic outlook).
- Credit institutions **should not restrict** significant increases in credit risk to situations when a financial instrument is **anticipated to become credit-impaired** (i.e. the third stage of IFRS 9).
- The **identification of credit risk drivers** and demonstration of the **linkages** between them and the level of credit risk, should be considered as critical.
- Credit institutions should give thorough consideration and full weight to **discretionary decisions** by the **management body or senior management** which point to a change in credit risk.
- When a credit institution assesses that there has been a significant increase in credit risk **for some, but not all, of its lending exposures** to a counterparty it should ensure that all lending exposures are identified where there has been a significant increase in credit risk.
- Where a credit institution makes the assessment of significant increases in credit risk on a **collective basis**, the **definitions of portfolios should be reviewed regularly** to ensure that the lending exposures within them continue to share risk characteristics in terms of their response to credit risk drivers[3].

(1) In accordance with IFRS 7 – Financial Instruments: Disclosures.
(2) Paragraphs B5.5.17 (a-p) of IFRS 9.
(3) According to IFRS 9, in a group of lending exposures, where some of them have experienced a significant increase in credit risk, a proportion of them should be transferred to lifetime ECL.

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Guidelines specific to credit institutions applying IFRS 9

In particular, the EBA provides guidance with regard to the systems and controls for the assessment of significant increases in credit risk, the information to be used in this assessment, and the policy that credit institutions should have on what constitutes a 'significant increase'

Assessment of significant increases in credit risk (3/3)

Policy on 'significant Increase' (cont.)

- Credit institutions should rigorously **review the quality of their approach** to assessing whether credit risk has increased significantly. A credit institution's **management body or senior management** should consider whether there are **additional factors** that should be taken into account in the assessment of significant increases in credit risk which would improve the quality of their approach.
- Lending exposures transferred to lifetime ECL that are **subsequently renegotiated or modified**, and not de-recognised, should not **move back to 12-month ECL measurement** unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly.
  - To this end, they should ensure that modifications or renegotiations **do not obscure increases in credit risk** and thereby cause ECL to be underestimated and to delay the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated, or inappropriately result in a move from lifetime ECL measurement back to 12-month ECL measurement.
  - In this regard, credit institutions should consider some **factors** (e.g. whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, whether factors support a credit institution's assessment of the obligor's ability to repay the debt, etc.).

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Detail

Guidelines specific to credit institutions applying IFRS 9

IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies. In this regard, the GL addresses the following elements: the information set, the 'low credit risk' exemption, and the 30-days-past-due presumption

Use of practical expedients

Practical expedients

- Credit institutions should make **limited use of practical expedients** as these have the potential to introduce significant bias and because the cost of obtaining relevant information is not likely to involve 'undue cost or effort'. To avoid such bias, they should consider to make **adjustments** when using practical expedients.
- Where credit institutions use practical expedients, justifications for their use should be clearly **documented**.

Information set

- Credit institutions should develop systems and processes that use all **reasonable and supportable information that is relevant** to the group of exposures or individual exposure, as needed to achieve a high-quality, robust and consistent implementation of the accounting requirements[1].

'Low credit risk' exemption

- Credit institutions have the option for '**low credit risk' exposures** not to assess whether credit risk has increased significantly since initial recognition, although the **use of this exemption should be limited**. Thus, they should conduct timely assessment of significant increases in credit risk for all lending exposures.
- The use of this exemption should be accompanied by **evidence** that credit risk as of the reporting date is sufficiently low that a significant increase in credit risk since initial recognition could not have occurred.
- For the purpose of the use of this exemption, credit institutions should rely primarily on their **own credit risk assessments** and not solely on external ratings (e.g. investment grade rating).

More than 30 days past due

- Credit institutions should **avoid** using the **more-than-30-past-due rebuttable presumption** as a primary indicator of transfer to lifetime ECL.
- Any assertion that the more-than-30-days-past-due presumption is rebutted on the basis that there has not been a significant increase in credit risk should be accompanied by a **thorough analysis** clearly demonstrating that 30 days past due is not correlated with a significant increase in credit risk. To this end, credit institutions should use **relevant forward-looking information**.

(1) Nevertheless, additional cost and operational burden do not need to be introduced where they do not contribute to a high-quality implementation of IFRS 9.

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Detail

Supervisory evaluation

Finally, the GL include a section specifically addressed to competent authorities, with guidance on the supervisory assessment of credit risk, accounting for ECL and capital adequacy

Supervisory evaluation of credit risk, accounting for ECL and capital adequacy

1 Credit risk management assessment

- CAs should **periodically evaluate** the effectiveness of a credit institution's credit risk practices. This evaluation should include at least, but not limited to, whether the credit institution's internal credit risk review function is robust and encompasses all lending exposures; the quality of a credit institution's processes and systems for identifying changes in credit risk is adequate; appropriate information about the credit risk of lending exposures is provided to the management body and senior management on a regular basis; etc.
- CAs may require institutions to provide **supplemental information**, not publicly disclosed, through **ad hoc reporting or on-site examinations**.

2 ECL measurement assessment

- CAs should be satisfied that the policies and practices employed by a credit institution are **consistent with the ECL measurement principles** outlined in these GL, including, but not limited to, the following: the procedures used to measure ECL are robust and timely; the framework and methodology for establishing allowances are robust; aggregate allowances are appropriate in relation to the credit risk exposure; etc.
- CAs should scrutinise the use of **practical expedients**.
- They may make use of the work performed by **internal and external auditors**.

3 Capital adequacy assessment

- CAs should also consider a credit institution's credit risk practices when assessing its **overall capital adequacy**. In this regard, CAs should ensure that institutions:
  - Maintain effective systems and controls for identifying, measuring, monitoring and controlling the level of credit risk, significant increases in credit risk and asset quality problems in a timely manner.
  - Analyse all significant relevant factors that affect credit risk and the collectability of the portfolio.
  - Establish an acceptable allowance estimation process that meets the principles set out in these GL.
- Where CAs identify **deficiencies** when assessing credit risk practices, they should consider how these deficiencies affect the level of reported allowances. The CA should discuss this with the senior management and management body and take **further appropriate supervisory action**.
  - Where deficiencies are significant, CAs should consider imposing **additional own funds requirements**.

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The GL should be implemented at the start of the first accounting period beginning on or after 1 January 2018

Next steps

- These GL should be implemented at the start of the **first accounting period beginning on or after 1 January 2018**. This is consistent with the effective application date of IFRS 9.
- The EBA also understands that implementation efforts are ongoing and are expected to be constantly evolving until the initial application of IFRS 9. Therefore, credit institutions may decide to consider the content of this GL before the initial application of IFRS 9.

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Annex 1
Main changes compared to the consultative document

Two amendments introduced in relation to the principle of proportionality and the use of practical expedients should be highlighted

Main changes compared to the consultative document

	Comments by respondents	Amendments by the EBA
1 Proportionality	• Several respondents noted that **immaterial and non-complex portfolios** should be explicitly considered in the context of the **proportionality principle**, since immaterial portfolios of large credit institutions may also face implementation issues and therefore also should benefit from applying the proportionality principle.	• The EBA recognises that the appropriate approach to proportionality needs to consider, in addition to entity factors (e.g. size, business model, complexity, cross-border activity or the existing use of the SA or the IRB approach), **portfolio factors** (e.g. complexity, materiality and available data).
2 Practical expedients	• Some respondents considered the GL too prescriptive regarding the use of practical expedients, as they allow practical expedients to be applied only in the case of **smaller and less complex credit institutions**.	• On the use of practical expedients, the GL should be applied in accordance with the proportionality principle, which is relevant throughout the guidelines. Therefore, the **reference to smaller and less complex credit institutions** has been **removed** from the text.

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Annex 2

Principle 2: Sound ECL methodologies

The EBA includes a list of requirements that ECL methodologies for assessing credit risk and measuring the level of allowances should adhere to for them to be considered sound

Sound ECL methodologies for assessing credit risk

Requirements

- Sound methodologies for assessing credit risk and measuring the level of allowances should:
  a) Include a robust process designed to equip the credit institution with the **ability to know the level, nature and drivers of credit risk** upon initial recognition of the lending exposure.
  b) Include criteria to consider the **impact** of forward-looking information, including macroeconomic factors.
  c) Include a description of the **basis for creating groups of portfolios** with shared credit risk features.
  d) Identify and **document the ECL assessment and measurement methods**.
  e) Document the **reasons why the selected method is appropriate**, especially if different ECL measurement methods are applied to different portfolios and types of individual exposures.
  f) Document the **inputs, data and assumptions** used, how the **life of an exposure** is determined, etc.
  g) Include a process for evaluating the **appropriateness of significant inputs** in the ECL method chosen.
  h) Identify the **situations that would generally lead to changes** in ECL measurement methods, inputs or assumptions from period to period.
  i) Consider the **relevant internal and external factors** that may affect ECL estimates (e.g. changes in industry, geographical, economic and political factors, etc.).
  j) Address **how ECL estimates are determined.**
  k) Identify what factors are considered when **establishing appropriate historical time periods** over which to evaluate historical loss experience.
  l) Determine the extent to which the **value of collateral and other credit risk mitigants** affects ECL.
  m) Outline the credit institution's policies and procedures on **write-offs and recoveries**.
  n) Require that analyses, estimates, etc. are performed by **competent, independent and trained staff**.
  o) Document the **methods used to validate models** for ECL measurement (e.g. backtesting).
  p) Ensure that ECL estimates incorporate **forward-looking information**.
  q) Require a process to assess the **overall appropriateness of allowances** according to the accounting framework.

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