April 2020

Modeling ECL during the COVID-19 pandemic: Providing flexibility to avoid procyclicality

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Overview

As the COVID-19 pandemic spreads and the global economy continues to weaken, the credit risk of many borrowers is expected to increase, which would require banks to hold additional capital against these risks under new ‘expected credit losses’ (ECL) accounting standards. The focus of this IIF Staff Paper is on how these new ECL standards — both IFRS 9 and CECL¹ — work, how these rules introduce procyclicality under deteriorating credit conditions, especially if the shock is material, and what actions and guidance authorities have issued so far to help give banks sufficient flexibility to avoid excessive procyclicality throughout these current, exceptional, albeit temporary, circumstances.

Introduction

With the current COVID-19 pandemic already showing a severe impact on the global economy and financial markets, parallels start to get drawn to the global financial crisis. The 2008 crisis was followed by unprecedented regulatory reforms which were designed to avoid a similar crisis in the future. In the accounting sphere, one of the most notable changes was the switch from incurred loss models to expected loss models in credit provisioning — both by the Financial Accounting Standards Board (FASB) via the Current Expected Credit Losses (CECL) standard and by the International Accounting Standards Board (IASB) via the International Financial Reporting Standard 9 (IFRS 9). Most banks around the world file their financial statements in accordance with IFRS, whereas U.S. banks and a few others report under U.S. GAAP, and are therefore impacted by the new CECL approach.

These changes followed a request by the G20 and the Financial Stability Board (FSB) to address the issue of procyclicality. Under the previous incurred loss methodologies, provisions against increased credit risk were only taken when those risks materialized. Hence, these models responded to actual rather than possible events. The new ECL methodologies can have material consequences for banks as they directly impact the regulatory capital calculations

¹ IFRS 9 is an International Financial Reporting Standard (IFRS) published by the International Accounting Standards Board (IASB). It addresses the accounting for financial instruments and is applicable to most banks around the world. Current Expected Credit Losses (CECL) is a new credit loss accounting standard (model) that was issued by the Financial Accounting Standards Board (FASB) and is relevant mainly for U.S. banks.
under the Basel Capital Framework\(^2\), since accounting provisions affect regulatory capital through the profit and loss statement (see Box 1).

Incurred credit loss models have been criticized for underestimating the risks during a boom period and resulting in a disproportionally higher capital provisioning during a downturn, thereby creating a procyclical effect.

However, both CECL and IFRS 9 have been developed with features that also have the effect to act procyclical in a severe economic downturn — like the one most countries and many borrowers are facing at the moment — and can potentially lead to a tightening in credit availability at a time when credit would be most needed. There’s a lot of uncertainty around the application of these standards in such an unprecedented situation, since the economic impact could be materially significant, but is expected by many regulators to be temporary in nature.\(^4\)

Before examining the issue of procyclicality in the ECL models, this paper will briefly discuss the main characteristics of both frameworks. Both CECL and IFRS 9 require banks to estimate expected losses over the entire lifetime of a loan and to take provisions as soon as a loan is issued — reflecting the assumption that every loan has a chance of default. The idea behind the framework is forward-looking: in case losses materialize, banks would have already built reserves to cover these losses — presumably acting countercyclical.

Even though the underlying core concept for CECL and IFRS 9 is the same, there are notable differences in how the frameworks were developed.

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\(^2\) For the standardized approach (SA) and for the internal ratings-based approach (IRB), if there is an IRB provision excess.

\(^3\) For more details, see BIS statement ‘Accounting provisions and capital requirements’ from July 30, 2018 (https://www.bis.org/fsi/fsisummaries/acprov.htm) and BIS statement ‘Regulatory treatment of accounting provisions’ from January 13, 2017 (https://www.bis.org/bcbs/publ/d385.pdf).

\(^4\) To put it in the words of Sam Woods, Deputy Governor and CEO of the Prudential Regulation Authority (PRA): “It is important to recognise that, while the reduction in activity associated with Covid-19 could be sharp and large, it is likely to rebound sharply when social distancing measures are lifted.” (PRA Letter, March 26, 2020: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants.pdf?la=en&hash=77F4E1D06F713D2104067EC6642FE95EF293EBD)

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Box 1 – How ECL impacts bank capital\(^3\)

*Both IFRS 9 (used by banks around the world) and CECL (namely applicable to U.S. banks) are measurement approaches for how credit losses should be accounted for in financial statements. When loans are originated banks allocate capital reserves against possible future losses. Although there are differences in approach, both IFRS 9 and CECL require setting aside capital against expected losses (EL). In both cases, the capital set aside for EL (rather than incurred losses) directly impacts the regulatory capital calculations under the Basel Capital Framework. A ‘shortfall’ between eligible provisions and regulatory EL is deducted directly from CET1 capital, the highest quality of capital. Any ‘excess’ capital (where the provision is higher than the regulatory EL) is added to Tier 2 supplementary capital, up to a limit of risk weighted assets.*

*The specific capital impact differs for banks under the standardized approach (SA) and for banks under internal ratings-based (IRB) approaches, but it can impact both CET1 and Tier 2 capital.*
IFRS 9 in brief

Effective date: IFRS 9 became effective for banks on January 1, 2018, meaning the standard is applicable for annual periods from this date onward.

Recognition of impairment: In IFRS 9, the impairment of financial assets is recognized in three stages:

- **Stage 1:** Expected credit losses within the first 12 months are recognized as soon as the financial instrument is originated or purchased, if the financial instrument is not credit-impaired at origination or purchase.
- **Stage 2:** Lifetime expected credit losses are recognized in case credit risk increases significantly (Significant Increase in Credit Risk, SICR).
- **Stage 3:** Lifetime expected credit losses continue to be recognized and interest revenue is calculated based on the amortized cost once the financial instrument is considered credit-impaired.

Transitional period: The transition to the new standard is particularly burdensome on the first day of its application, since it usually leads to a significant rise of allowances for losses of existing credits 'overnight.' In order to soften the burden of 'front-loading' losses on day 1, a five-year transitional period has been agreed for IFRS 9 in Europe under the Capital Requirements Regulation (EU) No 575/2013, which allows preparers to spread the day 1 capital impact over the period of five years.

CECL in brief

Effective date: CECL took effect in 2020 for almost all banks that have publicly traded equity (so-called 'SEC Filers'), including the eight U.S. G-SIBs. In October 2019, the FASB delayed the effective date for other companies to 2023.

Recognition of impairment: While IFRS 9 works with a three-stage approach for the impairment of financial assets, CECL forces preparers to recognize the expected credit losses over the entire lifetime as soon as the financial instrument is originated or purchased. Banks then adjust their loan loss provisions during the lifetime in case their initial assessment of loan default changes over time.

Transitional period: Like IFRS 9, a transitional period was agreed for CECL — however, in the case of CECL, banks were allowed to phase in their day 1 capital impact over three years.

While the frameworks are different, their impacts are expected to be the same. IFRS 9 preparers have seen an increase of capital requirements due to the new framework. A study by EY in July 2018 found that 18 of the 20 banks participating in the study saw impairment provisions...
increasing at adoption, with 50% of the banks seeing an increase of at least 10%.\(^8\) Banks operating under CECL have not yet published their first filings, which will commence with 1Q 2020 reporting, but one large U.S. bank has previously noted that credit losses rose 30% due to the adoption of CECL.

**Procyclicality**

As mentioned earlier, ECL models in credit provisioning were designed to tackle the problem of procyclicality. A measure acts procyclical if it exacerbates a given business cycle. The idea behind such frameworks was to build up reserves in good times which could be used in bad ones. However, especially in a severe economic downturn, the practical effect of ECL models is the opposite — particularly during an economic downturn as the one we are very likely facing right now.

In a severe economic downturn, the risk of loan losses increases significantly. This effect is further amplified by macroeconomic models and macroeconomic forecasts, because they are generally unable to predict the exact turning points in the business cycle. Since this would lead to higher expected credit losses, banks would have to raise their credit impairment allowances — even if creditors are still paying on time (the main difference to the previous model\(^9\)). This effect might play out differently in the two frameworks: Due to the 3-stage-model it may take longer to see the increase in allowances in IFRS 9; however, due to the movement of exposures from Stage 1 to 2 following SICR triggers, the capital impact might be even more dramatic during a downturn. Despite these differences, both models would contribute to a tightening in credit availability at a time when credit would be most needed for banks to be able to support the wider economy with additional credit.

It is very difficult to assess the eventual economic impact of COVID-19, but it is already clear that whole sectors are at risk (e.g. airlines, hospitality, restaurants, live entertainment) and that global economic growth is expected to slow considerably.\(^10\) In this case, loan loss provisions would jump significantly, eating into banks’ capital buffers and absorb much of the capital relief that has already been announced by central banks around the world. To offset this increase in capital requirements, banks would have to reduce lending and thereby act procyclical, further prolonging the downturn. There is also a wide belief that the impact of the pandemic will be temporary, and the global economy will rebound. That means that in this case capital is being locked up for many expected losses that are highly likely to recover. Therefore regulators, standard-setting bodies, banks and their auditors believe it is essential to address this problem.

**Policy Response**

Given the need to avoid excessive procyclicality due to the worsening economic conditions and considering that this crisis, albeit material, will be temporary (until ‘social distancing’ measures are suspended), authorities and standard setters around the world are introducing

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\(^{8}\) EY 2018: “EY IFRS 9 Impairment Banking Survey”, July 2018

\(^{9}\) Even if the previous models focused on incurred losses instead of expected losses, it is important to say that under the incurred losses models firms would have seen an increase in reserves as well since some borrowers are already under pressure. However, it is reasonable to believe that the immediate impact would have been less significant.

\(^{10}\) The economic impact of COVID-19 has been moving at lighting speed. For example, on March 23, 2020, the IIF cut its 2020 global growth forecast to 0.4% from a forecast of 2.6% just two weeks earlier. ([https://www.iif.com/Portals/0/Files/content/1_IIF032320_GMV.pdf](https://www.iif.com/Portals/0/Files/content/1_IIF032320_GMV.pdf))
measures and issuing guidance to help give banks sufficient flexibility to avoid excessive procyclicality during these exceptional circumstances.

First turning to the IFRS side, authorities and standard setters have released very similar guidance for banks to address the problem:

On March 20, 2020, the European Central Bank (ECB) announced flexibility to banks in reaction to COVID-19. In a statement, the ECB stated that “excessive volatility of loan loss provisioning should be tackled at this juncture to avoid excessive procyclicality of regulatory capital and published financial statements.” The ECB recommended “that all banks avoid procyclical assumptions in their models to determine provisions and that those banks that have not done this so far opt for the IFRS 9 transitional rules.”

On April 1, 2020, the ECB published further detailed considerations that they expect significant institutions to take into account when using forecasts to estimate ECL. Where information is only available at the collective level and not for individual clients, the ECB expects significant institutions to “recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly without the need to identify which individual financial instruments have suffered a SICR.” Where there is no reliable evidence for specific forecasts and long-term macroeconomic outlooks will provide the most relevant basis for estimation, the ECB encourages signification institutions to use their own macroeconomic research and reliable external sources.

Also, on March 20, 2020, the Bank of England (BoE) and the Prudential Regulation Authority (PRA) in the U.K. published a statement outlining the issues of reasonable and supportable forecasts for the purposes of IFRS 9 in the current crisis. “Given the sudden onset of the virus, the PRA believes that there is very little such information available as yet and regards the preparation of reliable and detailed forecasts as very challenging currently.” In case such forecasts are made, “the PRA expects firms to reflect the temporary nature of the shock, and fully take into account the significant economic support measures already announced by global fiscal and monetary authorities. In particular, any such forecasts should take into account the relief measures - such as repayment holidays - that will be made available to enable borrowers who are affected by the Covid-19 outbreak to resume regular payments.”

In a letter to Chief Executive Officers of UK Banks from March 26, 2020, Sam Woods, Deputy Governor and CEO of the PRA, again warned “that a significant overstatement of ECL could prompt behaviour that leads to unnecessary tightening in credit conditions.” He further elaborated on the previous guidance and explained that steps being taken to contain the virus

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— like business closures — should “not be judged in isolation because governments and central banks globally have announced unprecedented interventions to minimise the impact on individuals and corporates.” On the lifetime probability of default, he noted that “many [borrowers] will need the support measures in the short-term but will not suffer a deterioration in their lifetime probability of default.”

On March 25, 2020, both the European Banking Authority (EBA)\(^{15}\) and the European Securities and Markets Authority (ESMA)\(^{16}\) released aligned statements, stating that “the principles-based nature of IFRS 9 includes sufficient flexibility to faithfully reflect the specific circumstances of the COVID-19 outbreak and the associated public policy measures.” The Authorities noted that the high degree of uncertainty might now allow issuers to generate reasonable and supportable short-term economic forecasts as required by IFRS 9. On the issue of forbearance, the issuers made clear that “the measures that governments and credit institutions are proposing to address the adverse systemic economic impact of the COVID-19 pandemic would not automatically lead to a reclassification under the definition of forbearance,” since “these measures are not borrower-specific.” EBA later published detailed guidance on the treatment of public and private moratoria in light of COVID-19 measures.\(^{17}\)

On March 27, 2020, the International Accounting Standards Board (IASB)\(^{18}\) published guidance stating that “in the current stressed environment, IFRS 9 and the associated disclosures can provide much needed transparency to users of financial statements.” At the same time, and similar to the FASB for CECL, IASB noted that they had been “closely engaged with many prudential and securities regulators and others regarding the application of IFRS 9 in the context of the covid-19 pandemic” and encouraged entities whose regulators have issued guidance to consider that guidance — explicitly mentioning EBA, ECB, ESMA, PRA and the Malaysian Accounting Standards Board (MASB)\(^{19}\).

On March 27, 2020, the Office of the Superintendent of Financial Institutions (OSFI)\(^{20}\) in Canada announced guidance on how to apply IFRS 9 in extraordinary circumstances arising from COVID-19: “In determining the economic impacts of COVID-19, DTIs [Federally Regulated Deposit Taking Institutions] are encouraged to consider the exceptional circumstances, significant government support, the high degree of uncertainty and established long-term economic trends evidenced by past experience in determining reasonable and supportable forward-looking information.” OSFI also stated that, in their view, “the utilization of a payment

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\(^{19}\) The MASB published a statement for the corresponding MFRS 9 on March 25, 2020: “In the event that forecasts are made to measure expected credit losses, reporting entities take into account the range of information available, including the expected impacts of government measures to mitigate the effects of the expected challenges, the expected duration and the extent of the current challenging conditions.” (http://www.masb.org.my/pdf.php?pdf=MFRS%20ECL%20-%20COVID-19%20v9b-letterhead-25Mar.pdf&file_path=pdf_file)

deferral program should not result in an automatic trigger, all things being equal, for significant increase in credit risk.”

On April 3, 2020, the International Organization of Securities Commissions (IOSCO) published guidance endorsing the statements from IASB and confirming IOSCO’s support for coordinated approaches.

On the CECL side, similar guidance was issued by the regulators and by FASB, the relevant standard setter:

An interagency statement from six U.S. agencies — including the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) — was published on March 22, 2020. The U.S. agencies noted that they “view prudent loan modification programs offered to financial institution customers affected by COVID-19 as positive and proactive actions that can manage or mitigate adverse impacts on borrowers, and lead to improved loan performance and reduced credit risk.” They committed to “not direct supervised institutions to automatically categorize loan modifications as troubled debt restructurings (TDRs).” They also made clear that “[s]hort-term modifications [such as payment deferrals, fee waivers, extensions of repayment terms] made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs.”

The Financial Accounting Standards Board (FASB) stated that this guidance “was developed in consultation with the staff of the FASB who concur with this approach and stand ready to assist stakeholders with any questions they may have during this time.”

On March 27, 2020, the Fed, the FDIC, and the OCC issued another joint statement with guidance on the implementation of CECL: “Banking organizations that are required under U.S. accounting standards to adopt CECL this year can mitigate the estimated cumulative regulatory capital effects for up to two years. This is in addition to the three-year transition period already in place. Alternatively, banking organizations can follow the capital transition rule issued by the banking agencies in February 2019.” In this way, the amendment gradually phases in the full effect of CECL on regulatory capital, providing a 5-year transition period.

On the same date, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law. Section 4014 of the CARES Act stated that “no insured depository institution, bank holding company, or any affiliate thereof shall be required to comply with […] the current expected credit losses methodology for estimating allowances for credit losses, during the period beginning of the date of enactment of this Act and ending on the earlier of (1) the date on which the national emergency […] terminates; or (2) December 31, 2020.” In another joint

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statement on March 31, 2020, Fed, FDIC, and OCC clarified how the CARES Act and the interim final rule from March 27, 2020 interacted.

On April 3, 2020, the Basel Committee on Banking Supervision (BCBS) set out additional measures to alleviate the impact of COVID-19 on the global banking system. BCBS reiterated the importance of ECL frameworks, referring to both IFRS 9 and CECL, but urged banks to “use the flexibility inherent in these frameworks to take account of the mitigating effect of the extraordinary support measures related to Covid-19.” It reiterated that “extraordinary support measures should be taken into account by banks when they calculate their ECLs.” More specifically, it noted: “Regarding the SICR assessment, relief measures to respond to the adverse economic impact of Covid-19 such as public guarantees or payment moratoriums, granted either by public authorities, or by banks on a voluntary basis, should not automatically result in exposures moving from a 12-month ECL to a lifetime ECL measurement.”

Further Considerations

While the statements from regulators and accounting standard-setting bodies are helpful in offering guidance on how to prevent major credit impairment impacts in the current situation, banks will be expected to have questions, particularly regarding the operationalization of this guidance. As stated in a recent EY paper: “While the IASB and the regulators are right to emphasise the effects of government programmes, doing so will be challenging. The government interventions vary by country, they are currently evolving and the details are often not yet clear. Also, assessing the impact on different classes of borrowers will not be easy.”

Also, there is a risk of market fragmentation if respective competent authorities provide different guidance and guidance with differing granularity on how to respond to this crisis. It should be acknowledged that authorities themselves have called for global coordination — as exemplified in a statement from the PRA’s Sam Woods: “We recognise the need for regulatory measures to respond to Covid-19 to be well coordinated. The PRA has been discussing and sharing information with other regulators both domestically and internationally, including coordination of policy and supervisory responses through the Basel Committee. We will continue to actively engage in these discussions.”

The IIF strongly concurs on the need for regulatory coordination and harmonization. While we welcome cooperation around ECL-related guidance, the crisis could lay bare the differences in approaches between IFRS 9 and CECL. As we have outlined above, there are differences between IFRS 9 and CECL, for instance regarding models as well as timelines. This already adds complexity for major banks that are active in both jurisdictions and need to reconcile both approaches. It would be useful for the Basel Committee, for example, to analyze the impact of both frameworks on regulatory capital and whether there are significant differences due to the staging under IFRS 9 versus lifetime provisioning under CECL. The IIF sees the Basel Committee as having an important role in bringing together regulators to consider the impacts of both ECL approaches.

27 EY 2020: “IASB and regulators highlight IFRS 9 ECL requirements during the coronavirus pandemic” (IFRS Developments, Issue 163), March 2020