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Novel Challenges from "Novel Risks"

Next level requirements for IFRS 9 provisioning

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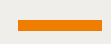

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Novel Challenges from "Novel Risks",

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01.

IFRS 9 provisioning in the sights of ECB

In July 2024, ECB has published a benchmark report on the use of overlays in incorporating "novel risks" (NR) in IFRS 9 Expected Credit Loss (ECL) models.[1] NR are also supervisory priorities of the ECB for 2026 – 2028 and will therefore be addressed accordingly in corresponding onsite inspections (OSI) and the SREP.[2]

The following risks are considered "novel" since they are often not sufficiently reflected in banks' existing ECL models:

- Environment, social and governance (ESG) risks
- Geopolitical risks
- Energy supply risks (if not already part of geopolitical risks)
- Supply chain risks (e.g. due to Covid-19)

Inflation and interest rate risks are sometimes added to this list assuming that high inflation and sharp interest rate changes as seen in the recent years were often not present in the model development samples of many banks.

NR are typically characterized by disruptive changes in the economic regime, which makes their quantification on the basis of banks' own data histories difficult and requires other estimation techniques and further sources of (quantitative) evidence. As a result, banks have so far mostly relied on out-of-model overlays – or have argued that such risks are irrelevant for their portfolio. The ECB welcomes the use of overlays but requires sound practices in applying them, thus promoting a level playing field in the banking market.

A key point is ECB's preference for in-model adjustments compared to top-level ("umbrella") adjustments: Overlays that are in-model adjustments are more transparent, and their quantification can be scrutinized by supervisors. It is worth noting that balance sheets of some European (SSM) banks are still showing top-level (or similarly named) adjustments in a range of 50% to 60% of their peak[3] during the Covid-19 pandemic, offering substantial leeway for earnings management.

In-model adjustments could include:

- Adjustments of ECL model input data
- Additional scenario narratives (and related weights) and / or modification of existing scenarios to incorporate novel risks
- Adjustments of ECL model parameters, e.g. PDs for certain industries
- Collective assessment of Significant Increase of Credit Risk (SICR, stage 2)

1 ECB, "IFRS 9 overlays and model improvements for novel risks – Identifying best practices for capturing novel risks in loan loss provisions", July 2024.

2 https://www.bankingsupervision.europa.eu/framework/priorities/html/ssm.supervisory_priorities202511.en.html

3 d-fine analysis of published financial statements

02. Banks are forced to act

The incorporation of NR in IFRS 9 provisioning is a consequence of the above-cited ECB benchmark report and published supervisory priorities and thus must be considered by all ECB supervised banks. The ECB has also emphasized that it will use the full weight of the powers granted to it by the SSM Regulation for this purpose.[4] Moreover, since ECB requirements can be expected to become market practice, the key messages of this section are also relevant for other banks since national competent authorities (NCAs) tend to adopt these standards.

1 Overlays or temporary adjustments will remain an inherent characteristic of IFRS 9 provisioning since the economic environment is constantly changing. It is, however, key to provide a consistent rationale for each overlay. In particular, it is not possible any more to form aggregated top-level adjustments without a detailed explanation (see also point 2).

2 Umbrella approaches and legacy models for NR that do not take the specific risk profile of individual loans or commitments into account are likely to be viewed increasingly critically by auditors and regulators. In notable cases where the auditors found that the derivation of the overlays for NR was not based on a sufficiently granular approach for individual portfolios and/or the correlation of the various risk factors was not explicitly taken into account, the approaches of the respective banks were assessed as being not fully compliant with the requirements of IFRS 9 5.5.17 and B5.5.51-52 (i.e. the requirement to use available reasonable and supportable information).

3 Many banks use a 12-month PD to assess the "significant increase in credit risk" (SICR), which is a valid approximation in many situations (cf. IFRS 9 B5.5.13 – B5.5.14). For financial instruments exposed to NR increasing during their lifetime (e.g. climate transition risks) this 12-month PD might no longer be adequate. Banks should thus re-assess their SICR approach when NR are material and switch to a lifetime PD-based approach.

4 When NR are difficult to assign to individual clients or financial instruments, banks should apply a collective staging approach if NR would otherwise be ignored for staging. In the so-called "top-down" approach of collective staging (cf. IFRS 9 Implementation Guide paragraph IE39) individual financial instruments cannot be identified, but it is assumed that a certain known fraction of a portfolio should be in stage 2.[5]

5 Another consequence of the importance of NR – although not explicitly mentioned by the ECB[6] – is the need for specific scenarios focusing on the impact of NR on a bank's loan portfolio (or certain parts of it), which are not necessarily based on standard macro-economic indicators alone.

6 Conservative add-ons are not a way to compensate for a missing treatment of NR. In particular, the ECB requirements do not establish a prudential interpretation, i.e., the goal is not to increase the provision but to make them more accurate and transparent.

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4 In particular the power to require institutions to apply a specific provisioning policy (cf. Council Regulation (EU) No 1024/2013 Art. 16 para. 2d).

5 If no other stage 2 triggers are present, the bank then calculates a weighted average of the 12-month and lifetime ECL for the portfolio using the known fractions in stage 1 and stage 2 as weights.

6 However, treating NR only via the aggregate impact on future GDP is considered a bad practice by the ECB in their July 2024 publication.

7 The framework for NR must be designed to be sufficiently flexible regarding additional supervisory requirements and / or prospective NR. Targeted and risk-sensitive approaches that allow flexible transparent adjustments will become more prevalent.

It should be noted that NR might have a prospective influence also on national GAAP provision reporting since the latter is often inspired by IFRS 9 (see, e.g., German IDW RS BFA 7).

2.1 Leveraging existing approaches paves the way to an efficient in-model adjustment

Approaches to incorporate several common NR into credit risk parameters are already well established in the market. In the following we discuss two prominent examples:

Physical climate risks[7]

Assessment of individual exposures based on high resolution risk maps

- The hazard likelihood (e.g. flooding, heat wave etc.) for different climate scenarios is often estimated on a high-resolution grid (e.g. 100m x 100m or finer).
- These climate risks can then be translated into credit risk parameter adjustments (PD, LGD) via pre-defined transmission channels (e.g. real estate collateral damage etc.) and thus allow for a quantitative scenario-based ECL adjustment.

Geopolitical risks

Semi-quantitative assessment based on geopolitical risk indices

- Public geopolitical risk indices[8] can be used as objective triggers to adjust the ECL of financial instruments linked to a certain country (e.g. loans to company whose main production site is located in this country).
- Care should be taken not to overemphasize the indices but rather calibrate them to internal data.
- Transmission channels are (sub-) segment specific since related risks often depend on industry or geographical location.
- Risk parameters for affected segments are either estimated using historical data with similar index values or assessed by expert opinion and cross-checked against historical data.

7 Details can be found in the d-fine whitepaper "Help from outer space – how to solve the green data challenge", April 2021.
8 For example, the Geopolitical Risk Index (Caldara and Iacoviello), the World Uncertainty Index (Ahir, Bloom, Furceri), or the Economic Policy Uncertainty Index (www.policyuncertainty.com).

2.2 Steering NR is as important as quantifying them

Beyond the immediately obvious purpose of considering NR – namely, transparent and robust provisioning and quantification of ECL adjustments in accordance with IFRS 9 – the development of a holistic novel risk management approach is equally important. This requires that an institution ideally knows and masters both

- risk drivers and transmission channels, as well as
- the levers to manage these NR (e.g. KPIs).

Transparency in the translation mechanism between those risk drivers and transmission channels on the one hand and ECL parameters (and stage transitions) on the other is a further motivation for in-model adjustments based on external factors and internal portfolio or even client-specific characteristics.

To ensure consistency across an institution's various risk management and steering instruments it is essential to align the approaches used in IFRS 9 provisioning with those in other areas of credit risk management (credit origination, ICAAP, pricing, etc.) – while respecting their different objectives. In this way, an integrated approach to managing NR can also pave the way for new business opportunities, for example, by strategically targeting previous no-go markets due to geopolitical risks with adequate loan pricing.[9]

03. How to start

To avoid criticism by regulators or auditors on the one hand but also to enable risk-based steering of NR on the other hand, banks need to devise methodologies to incorporate NR into their provision calculations relying not solely on top-level adjustments.

As short-term measures we recommend banks to perform the following steps which primarily help to avoid findings:

1 Link the NR included in IFRS 9 to the materiality assessment of the risk inventory.[10]

2 Create a systematic list of scenarios and affected exposures (e.g. in a workshop with all affected departments) and incorporate them into the forward-looking information where they are material.

3 Enhance the framework of written policies for NR related overlays. Top-level adjustments should only be permitted in exceptional situations while in-model adjustments should become the standard implementation of overlays. As part of these policies, establish rules and processes governing the application of model parameter adjustments.

9 This whitepaper focuses on the effects of NR on IFRS 9 provisions. An institution might, however, decide to approach NR in a much more holistic way, e.g. by hedging some of these risks through the issuance of financial instruments linked to specific NR-related events (think of catastrophe bonds as an example), or by establishing itself as a market maker for such products.
10 See, e.g., the EBA Guidelines 2025/01 on "Management of ESG risks" and 2025/02 on "Scenario analysis".

4 Enhance the institution's model validation framework accordingly. Prepare the necessary data sets and methods to implement back-testing of NR related overlays as set out in section 6.5 of the EBA IFRS 9 Implementation Monitoring Report issued in 2023 (EBA/Rep/2023/36).

5 Prepare an action plan to improve the incorporation of NR in IFRS 9 provisions in the medium-term, including the collection of required (external) data and the development of appropriate methodologies.

6 Start collecting data on drivers of NR (likelihood and severity) as well as on transmission channels to credit risk.

To strengthen steering capabilities of NR, the following additional steps should be performed in the medium term:

7 Prepare data and methods to assess the effects from NR on provisions in a quantitative manner.

8 Set up a monitoring and reporting framework for NR.

04. Summary

NR have become increasingly important, which is reflected in the greater scrutiny of auditors and supervisors with respect to them. Consequently, banks should identify the drivers and transmission channels of NR and make in-model rather than top-level adjustments to their provisions. This granular approach also allows a better management and steering of NR.

However, banks should not only strive to fulfil regulatory and reporting requirements but also consider NR as new realities in their business and credit risk management.

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