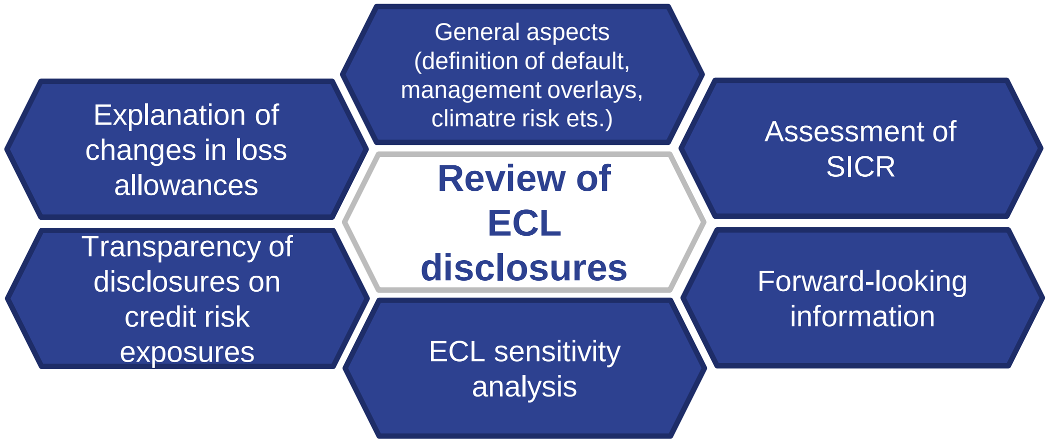
# ESMA's study on banks' ECL disclosures

## EFRAG TEG Meeting, 19 January 2022

ESMA32-51-879

# Background

- ESMA and the European enforcers have conducted a review of the 2020 financial statements of 44 European banks (mix of large systematically important banks, medium-sized and smaller banks) from 21 jurisdictions based on desktop examinations regarding compliance with the ECL-related requirements/principles of IFRS 9 and IFRS 7 (focus: compliance with disclosure requirements).
- Key review areas:




- The preliminary observations resulting for the review were taken into account when preparing ESMA's 2021 ECEP Statement.
- In September 2021, ESMA conducted a workshop with European banks and other stakeholders such as auditors, analysts, investors and academics to discuss the preliminary findings of the review.

# Background

- The final report was published on 15 December 2021 (https://www.esma.europa.eu/sites/default/files/library/esma32-339-169_report_on_the_application_of_the_ifrs_7_and_ifrs_9_requirements_regarding_banks_expected_credit_losses.pdf)
- The report includes examples of disclosures taken from the financial statements of some banks within and outside the sample.
- ESMA expects issuers, their auditors and audit committees to consider the findings of this report when preparing and auditing the financial statements.
- ESMA will use the input received for ESMA's response to the IASB's Post Implementation Review (PIR) of impairment requirements of IFRS 9 and related disclosure requirements of IFRS 7, which is expected to start in the second half of 2022.

# Selected workshop polling results

➢ For which aspects do you encounter difficulties when preparing ECL disclosures (only preparers):

### General aspects:

| | |
|---|---|
| Definition default, forborne, non-performing loans | 14% (6) |
| Credit-impaired assets / write-off policy | 12% (5) |
| **Management overlays** | **31% (13)** |
| **Climate-related risk factors** | **31% (13)** |
| Other general aspects | 9% (4) |
| No difficulties | 0% (0) |

### SICR assessment:

| | |
|---|---|
| Grouping of financial assets for SICR purposes | 10% (2) |
| **Information on SICR indicators and thresholds** | **31% (6)** |
| Use of practical expedients | 10% (2) |
| Application of a probation period | 10% (2) |
| Other SICR aspects | 21% (4) |
| No difficulties | 15% (3) |

### Forward-looking information (FLI):

| | |
|---|---|
| Disclosures on how scenarios are chosen | 13% (2) |
| **Disclosures on how ECL outcomes are linked to scenarios** | **46% (7)** |
| Disclosures of key parameters | 33% (5) |
| Other FLI-related aspects | 6% (1) |
| No difficulties | 0% (0) |

### Changes in loss allowances:

| | |
|---|---|
| **Level of disaggregation** | **34% (9)** |
| Reconciliation items | 15% (4) |
| Narrative explanations | 26% (7) |
| Explanations on how significant changes in the gross carrying amount contributed to changes in loss allowance | 19% (5) |
| Other aspects | 0% (0) |
| No difficulties | 3% (1) |

### Credit risk exposures:

| | |
|---|---|
| **Identification of the appropriate level of disaggregation** | **40% (9)** |
| Providing explanations on risk concentrations | 27% (6) |
| Disclosures on collateral and other credit risk enhancements | 27% (6) |
| Other aspects | 0% (0) |
| No difficulties | 4% (1) |

### ECL sensitivity analysis:

| | |
|---|---|
| **Determination of the relevant assumptions** | **50% (8)** |
| Determination of the level of granularity of the disclosures | 37% (6) |
| Other aspects | 12% (2) |
| No difficulties | 0% (0) |

➢ Is your perception of banks' SICR disclosures aligned with ESMA's observations?

| | General aspects | SICR assessment | FLI | Changes in loss allowances | Credit risk exposures | Sensitivity analysis |
|---|---|---|---|---|---|---|
| **Yes** | 60% | 60% | 70% | 77% | 77% | 70% |
| **No** | 0% | 0% | 0% | 0% | 0% | 0% |
| **Partly** | 40% | 40% | 30% | 22% | 22% | 29% |

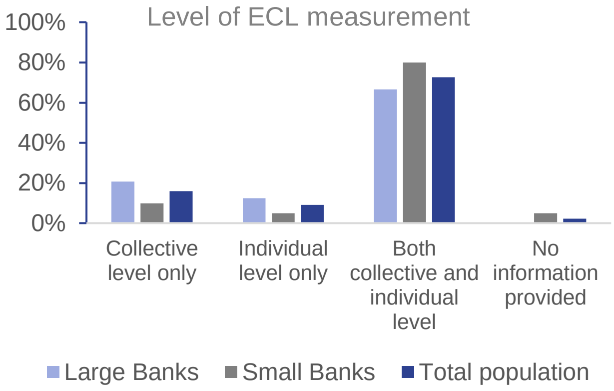
# Selected conclusions and recommendations (1 of 4)

## Overall conclusion and general observations

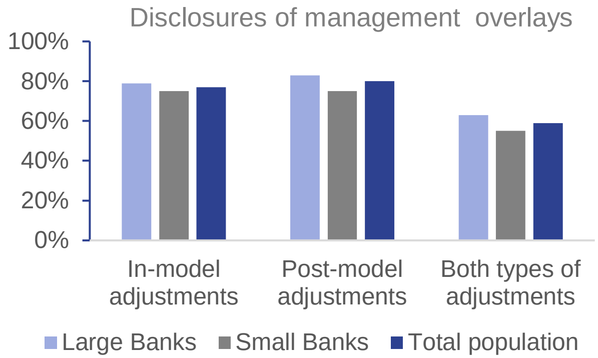
- ESMA and European enforcers identified room for improvement in the level of compliance, comparability and transparency in the application of the requirements.
- Low level of entity specific details and lack of narrative explanations in some areas.
- The ECL-related disclosures provided in different parts of the financial statements, in the management commentary or in the risk report should be better linked through cross-referencing.

## General aspects of credit management

- Banks did not always disclose sufficient entity-specific details regarding measurement of the 12-month and lifetime ECL (particularly regarding the issues that require application of judgement).




- Need of detailed and specific information for both post-model and in-model adjustments.



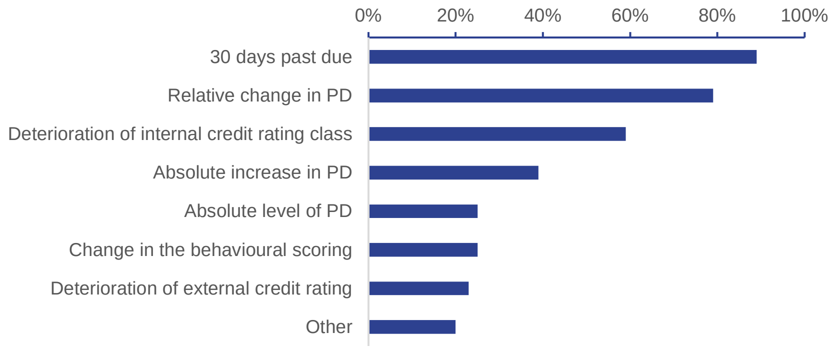

- Only very few banks in the sample provided ECL-specific climate-related disclosures. Banks should provide explanations, where applicable, on any credit risk concentrations related to environmental risks and how ECL are affected by those risks.

# Selected conclusions and recommendations (2 of 4)

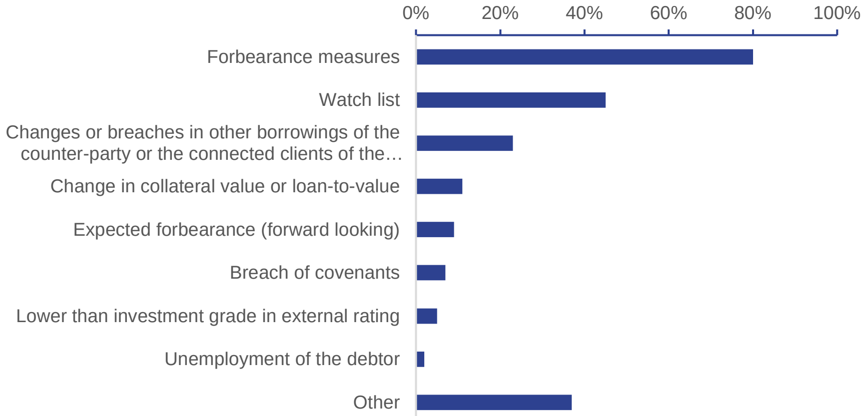
## Assessment of SICR

- SICR-related disclosures were often of a general nature and lacked entity-specific details with regard to the approach and significant judgements used in determination of SICR
- Insufficient description of the method for collective assessment used for SICR purposes (if applicable). Banks that grouped financial instruments for SICR assessment should disclose key risk characteristics of their grouping approach and how the collective assessment was performed as well as any change in grouping compared to previous reporting period.
- While several banks stated that economic support and relief measures did not imply an automatic trigger for SICR only a small number of banks provided more detailed information as to how the SICR for the exposures affected by these measures was assessed.
- Only one-third of banks that disclosed pandemic-related changes in SICR indicators provided detailed information on those changes. ESMA emphasises importance of detailed information on any significant changes in SICR assessment.

Quantitative SICR indicators used




Qualitative SICR indicators used by the banks



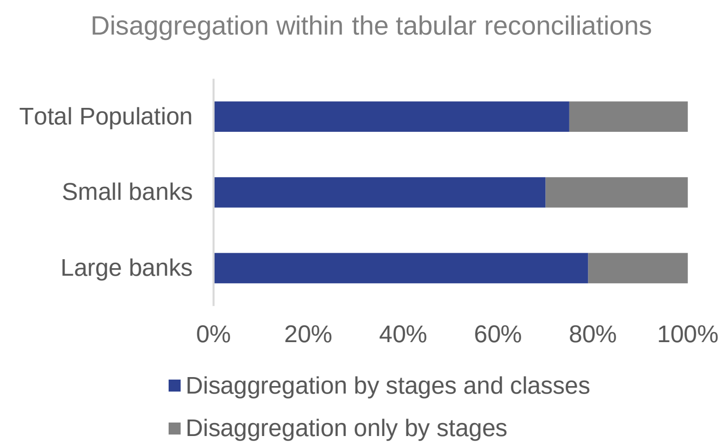
# Selected conclusions and recommendations (3 of 4)

## Forward-looking information

- Detailed explanations on how the impact of the pandemic was considered in the macro-economic scenarios in the 2020 provided in financial statements of many banks
- Need for more specific disclosures on the main judgements and estimations related to uncertainties that have been taken into account when defining the scenarios and to disclose the methodology used to determine the scenario weightings.
- More details of the specific approaches the banks use for incorporation of FLI in the estimation of PD, LGD and/or EAD are required.

## Explanation of changes in loss allowances

- Lack of detail in banks' explanations of changes in loss allowances. The disaggregation by class of financial instruments was often provided only to a very limited extent or not provided at all.

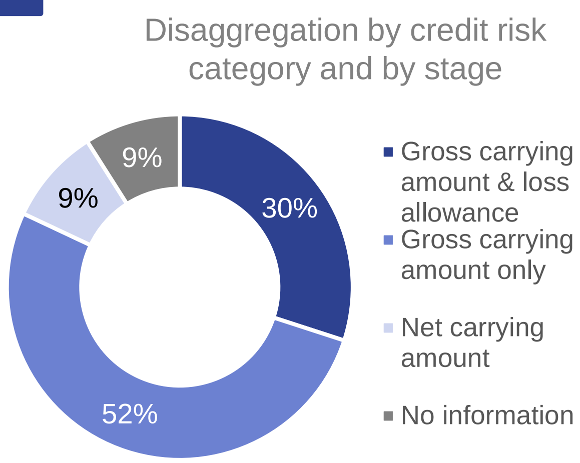



- Often no or insufficient narrative explanations of the reasons for the changes in the loss allowance.
- Explanations on how significant changes in the gross carrying amount contributed to changes in loss allowance were often not sufficiently detailed and could be improved.
- ESMA recommends that banks disclose a joint reconciliation of loss allowance and gross carrying amount and provide a direct link between ECL movements and income statement items.

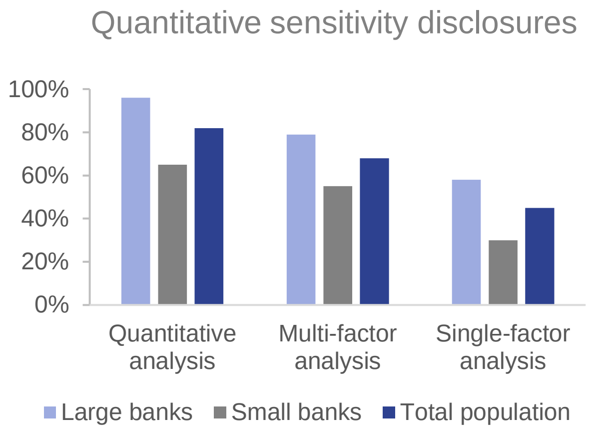
# Selected conclusions and recommendations (4 of 4)

## Transparency of disclosures on credit risk exposures

- Almost all banks disclosed quantitative data, in some cases with a high degree of disaggregation.
- ESMA recommends disclosing more narrative explanations of the quantitative data.
- Quantitative disclosures and the narrative descriptions included in different parts of the financial statements or in a management report should be better linked to each other.




## ECL Sensitivity analysis




- ECL sensitivity disclosures were of varying extent and quality.
- Only a relatively low number of banks in the sample disclosed a high quality explanation of changes in prior assumptions.
- ESMA emphasises the importance of providing granular disclosures on the sensitivity analysis and the quantitative impact of this analysis on the ECL and, where appropriate, on staging.

# Input to the IASB's PIR on IFRS 9 - Impairment requirements (initial considerations)

- ECL disclosures of different banks are not always comparable, which is partly due to the fact that the principle-oriented disclosure requirements in IFRS 7 are applied to different business models and risk management approaches.
- ESMA will further analyse, taking into account the enforcement cases, whether comparability can be improved through more detailed guidance in IFRS (in particular, with regard to management overlays, sensitivity analyses and an appropriate level of disaggregation of both credit risk exposures and changes in loss allowances).
- Examples of possible specific recommendations to the IASB (to be discussed):
  - Management overlays: specific guidance in IFRS 7
  - Changes in loss allowances: joint reconciliation of loss allowances and carrying values
  - Transparency of disclosures on credit risk exposures: Including allowances in breakdown of carrying values
  - Specific guidance in IFRS 7 on ECL sensitivity analysis.

THANK

YOU!