

In case of discrepancies between the French and the English text, the French text shall prevail.

Luxembourg, 20 December 2017

To all Luxembourg credit institutions, including their branches abroad, and to the Luxembourg branches of credit institutions originating outside the European Economic Area.

CIRCULAR CSSF 17/675

Re: Adoption of the Guidelines of the European Banking Authority on credit institutions' credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06)

Ladies and Gentlemen,

The purpose of this circular is to draw your attention to the Guidelines of the European Banking Authority (EBA) on credit institutions' credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06)¹ (the “Guidelines”) and with which the CSSF has committed to comply in its capacity as competent authority².

This circular, which adopts the Guidelines, applies to Luxembourg credit institutions, including their branches abroad, as well as to Luxembourg branches of credit institutions originating outside the European Economic Area (the “credit institutions”). It should be read together with Circular CSSF 14/593 on the supervisory reporting provisions as well as with Circular CSSF 12/552 on the central administration, internal governance and risk management and, in particular, its Chapter 3 dedicated to credit risk.

The Guidelines are based on the guiding principles on credit risk and accounting of expected credit losses established by the Basel Committee on Banking Supervision (“BCBS”) in December 2015³ and aim at specifying sound credit risk management practices for credit institutions in the context of the implementation and ongoing application of expected credit

¹ The Guidelines are annexed to this circular. They are also available at: https://www.eba.europa.eu/documents/10180/1965596/Guidelines+on+Accounting+for+ECL+%28EBA-GL-2017-06%29_FR.pdf/e9b4a941-6fb1-4341-82aa-71afc3ce6a0d (FR) https://www.eba.europa.eu/documents/10180/1965596/Guidelines+on+Accounting+for+ECL+%28EBA-GL-2017-06%29_EN.pdf/8a9a9df0-a0cc-406e-a781-7d4fb753495d (EN)

² “Significant supervised entities” as defined in Article 2(16) of Regulation (EU) No 468/2014 of the European Central Bank (“ECB”) of 16 April 2014 (“SSM Framework Regulation”) which are subject to the direct supervision of the ECB, shall refer to the ECB’s rules in this respect.

³ <https://www.bis.org/bcbs/publ/d350.pdf>

losses accounting models (hereafter “Expected Credit Losses” or “ECL”). It should be borne in mind in this respect that the adoption of IFRS 9 as from 1 January 2018 will induce material changes to the measurement and recognition of impairments for credit loss since these impairments must be estimated using an expected credit loss accounting model, taking into account forward-looking information, rather than an incurred credit loss accounting model (“Incurred loss” of the IAS 39).

The Guidelines introduce in particular:

- Eight principles relating to credit risk management practices and accounting for ECL:
 1. the accountability of the credit institution’s management body and senior management;
 2. the adoption of sound ECL methodologies resulting in their appropriate and timely accounting recognition;
 3. the existence of a credit risk rating process and grouping of credit exposures;
 4. the adequacy of the allowance consistent with the applicable accounting framework;
 5. the existence of policies and procedures to appropriately validate the models used to measure ECL;
 6. the use of experienced credit judgment during the assessment of credit risk and measurement of ECL;
 7. the existence of common processes, systems, tools and data to assess credit risk and account for ECL; and
 8. a financial disclosure promoting transparency and comparability allowing, in particular, users to make timely and informed decisions.
- Specific guidelines for the application of IFRS 9, in particular for the loss allowance at an amount equal to 12-month ECL, the assessment of significant increases in credit risk and the use of practical expedients intended to ease the implementation burden of the IFRS.

These requirements shall be complied with on an individual, sub-consolidated and consolidated basis.

This circular shall apply as from 1 January 2018.

Yours faithfully,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

Françoise KAUTHEN

Claude SIMON

Simone DELCOURT

Director

Director

Director

Annex: Guidelines of the European Banking Authority on credit institutions' credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06).



EBA/GL/2017/06

20/09/2017

Guidelines

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

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010¹. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision (ESFS) or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by 20.11.2017. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to compliance@eba.europa.eu with the reference 'EBA/GL/2017/06'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to the EBA.
4. Notifications will be published on the EBA website, in line with Article 16(3).

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p. 12).

2. Subject matter, scope, addressees and definitions

Subject matter

5. These guidelines specify sound credit risk management practices for credit institutions associated with the implementation and ongoing application of expected credit loss ('ECL') accounting frameworks.
6. These guidelines also provide competent authorities with guidance on evaluating the effectiveness of an institution's credit risk management practices, policies, processes and procedures that affect allowance levels.

Scope of application

7. These guidelines apply in relation to those credit institutions' credit risk management practices affecting the assessment of credit risk and measurement of expected credit losses from lending exposures and allowances under the applicable accounting framework. These guidelines also apply when, where permitted by the applicable accounting framework, the carrying amount of the lending exposure is reduced directly without the use of an allowance account. These guidelines do not set out any additional requirements regarding the determination of expected loss for regulatory capital purposes.
8. These guidelines build on Article 74 of Directive 2013/36/EU² which states that institutions must have adequate internal control mechanisms, including sound administration and accounting procedures that are consistent with and promote sound and effective risk management; and Article 79(b) and (c) of that Directive, which states that competent authorities must ensure that institutions have internal methodologies that enable them to assess the credit risk of exposures to individual obligors and at the portfolio level, and effective systems for the ongoing administration and monitoring of the various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, respectively. In addition, Article 88(1)(b) of Directive 2013/36/EU states the principle that 'the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards'. Finally, as specified in Article 104(1) of Directive 2013/36/EU, competent authorities may apply supervisory measures including requiring credit institutions to reinforce of the arrangements, processes,

² Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).



mechanisms and strategies implemented in accordance with Articles 73 and 74 (Article 104(1)(b)), the application of a specific provisioning policy or treatment of assets in terms of own funds requirements (Article 104(1)(d)).

9. Guidelines set out in section 4.3 only apply in relation to credit institutions which prepare their financial statements in conformity with the International Financial Reporting Standards® ('IFRS® Standards') adopted in accordance with Regulation (CE) 1606/2002³ and for which IFRS 9 *Financial Instruments* ('IFRS 9') applies.
10. For credit institutions to which ECL accounting frameworks do not apply, competent authorities should consider applying the relevant aspects of these guidelines related to credit risk management practices, as far as appropriate, within the context of the applicable accounting framework.
11. Competent authorities should ensure that credit institutions comply with these guidelines on an individual, sub-consolidated and consolidated basis in accordance with Article 109 of Directive 2013/36/EU.
12. Guidelines set out in section 4.4 should be considered as supplementing and further specifying the supervisory review and evaluation process (SREP) referred to in Article 97 and 107(1)(a) of Directive 2013/36/EU, in particular with regard to the assessment of credit risk management and controls and accounting for expected credit losses. Competent authorities should therefore comply with guidelines set out in section 4.4 in line with the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)⁴.

Addressees

13. These guidelines are addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010.
14. Guidelines set out in sections 4.1, 4.2 and 4.3 are also addressed to credit institutions as defined in Article 4(1)(1) of Regulation (EU) No 575/2013⁵.

³ Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L 243, 11.9.2002, p. 1).

⁴ EBA GL/2014/13.

⁵ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1-337).

Definitions

15. Unless otherwise specified, terms used and defined in Directive 2013/36/EU, Regulation (EU) 575/2013 and IFRS 9 have the same meaning in the guidelines. In addition, for the purposes of these guidelines, the following definitions apply:

Allowances	Means the stock of lending exposure loan loss provisions that has been recognised in the balance sheet of the credit institution, in accordance with the applicable accounting framework.
Lending exposures	Means loans, loan commitments and financial guarantee contracts to which an ECL framework applies ⁶ .
Temporary adjustments to an allowance	Means adjustments to an allowance used to account for circumstances when it becomes evident that existing or expected risk factors have not been considered in the credit risk rating and modelling process as of the reporting date.

⁶ The scope of the EBA guidelines may be different than the scope of the impairment requirements under the applicable accounting framework. For example, the scope of the EBA guidelines is narrower than the scope under IFRS 9.

3. Implementation

Date of application

16. These guidelines should be implemented at the start of the first accounting period beginning on or after 1 January 2018.

4. Guidelines on credit risk management practices and accounting for expected credit losses

4.1 General provisions

4.1.1 Application of the principles of proportionality, materiality and symmetry

17. Credit institutions should comply with these guidelines in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities and portfolios, and, more generally, all other relevant facts and circumstances of the credit institution (and the group (if any) to which it belongs). The use of properly designed proportionate approaches should not jeopardise the high-quality implementation of the ECL accounting frameworks.
18. Credit institutions should also give due consideration to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the credit institution. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of lending exposures such as real estate mortgages would generally be considered material even if they are highly collateralised.
19. In considering how to take proportionality or materiality into account in the design of an ECL methodology or in its implementation, it is important to ensure that bias is not being introduced.
20. 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 (both deteriorations and reversals of those deteriorations) in the credit risk profile of a debtor should be considered in the measurement of the allowances.

4.1.2 Consideration of reasonable and supportable information

21. Credit institutions should consider a wide range of information when applying ECL accounting models. Information considered should be relevant to the assessment of credit risk and measurement of ECL of the particular lending exposure being assessed, and should include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL should also be reasonable and supportable. Credit institutions should use their experienced credit judgement in determining the range of relevant information that

should be considered and in determining whether information is considered to be reasonable and supportable. Reasonable and supportable information should be based on relevant facts and sound judgement.

4.1.3 Consideration of forward-looking information

22. In order to ensure a timely recognition of credit losses, credit institutions should consider forward-looking information, including macroeconomic factors. When considering forward-looking information, credit institutions should apply sound judgement consistent with generally accepted methods for economic analysis and forecasting, and supported by a sufficient set of data.
23. Credit institutions should be able to demonstrate how they have considered relevant, reasonable and supportable information in the ECL assessment and measurement process. Credit institutions should apply experienced credit judgement in the consideration of future scenarios and take into account the potential consequence of events occurring or not occurring, and the resulting impact on the measurement of ECL. Information should not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. In certain circumstances information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. Given that these circumstances would be exceptional in nature, credit institutions should provide a clearly documented, robust justification.
24. The information used shall include an unbiased consideration of relevant factors and their impact on creditworthiness and cash shortfalls. Relevant factors include those intrinsic to the bank and its business or derived from external conditions.

4.2 Principles on credit risk management practices and accounting for expected credit losses

4.2.1 Principle 1 — Management body and senior management responsibilities

The management body⁷ and senior management of a credit institution 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 in accordance with the credit institution's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

⁷ Various management body structures can be observed in EU Member States. In some Member States a single-tier structure is common, i.e. supervisory and management functions of the management body are exercised within a single body. In other Member States a two-tier structure is common, with two independent bodies being established, one for the management function and the other for the supervision of the management function.

25. The credit institution's 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 set by the management body. In addition, to limit the risk that lending exposures pose to depositors and, more generally, financial stability, a credit institution's management body should require that senior management adopt and adhere to sound underwriting practices⁸.

26. To fulfil these responsibilities, the management body should instruct senior management to:

- a. develop and maintain appropriate processes, which should be systematic and consistently applied, to determine appropriate allowances in accordance with the applicable accounting framework;
- b. establish and implement an effective internal control system for credit risk assessment and measurement; report periodically the results of the credit risk assessment and measurement processes, including estimates of its ECL allowances;
- c. establish, implement and, as necessary, update suitable policies and procedures to communicate the credit risk assessment and measurement process internally to all relevant staff, in particular staff members who are involved in that process.

Senior management should be responsible for implementing the credit risk strategy approved by the management body and developing the aforementioned policies and processes.

27. An effective internal control system for credit risk assessment and measurement should include:

- a. measures to comply with applicable laws, regulations, internal policies and procedures;
- b. 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 competent authority are prepared in accordance with the applicable accounting framework and relevant supervisory requirements;
- c. well-defined credit risk assessment and measurement processes that are independent from (while taking appropriate account of) the lending function, which contain:

⁸ The Financial Stability Board published Principles for sound residential mortgage underwriting practices in April 2012, which aim to provide a framework for jurisdictions to set minimum acceptable underwriting standards for real estate lending exposures; available at www.financialstabilityboard.org/publications/r_120418.pdf. The EBA has published Guidelines on creditworthiness assessment (EBA/GL/2015/11) which are aligned with the FSB Principles and cover some of them.

- i. an effective credit risk rating system that is consistently applied, accurately grades differentiating by credit risk characteristics, identifies changes in credit risk on a timely basis, and prompts appropriate action;
 - ii. an effective process to ensure that all relevant and reasonable and supportable information, including forward-looking information, is appropriately considered in assessing credit risk and measuring ECL. This includes maintaining appropriate reports, details of reviews performed, and identification and descriptions of the roles and responsibilities of staff involved;
 - iii. an assessment policy that ensures ECL measurement occurs at the individual lending exposure level and also, when necessary to appropriately measure ECL in accordance with the applicable accounting framework, at the collective portfolio level by grouping exposures based on identified shared credit risk characteristics;
 - iv. an effective model validation process to ensure that the credit risk assessment and measurement models are able to generate accurate, consistent and unbiased predictive estimates, on an ongoing basis. This includes establishing policies and procedures which set out the accountability and reporting structure of the model validation process, internal rules for assessing and approving changes to the models, and reporting of the outcome of the model validation;
 - v. clear formal communication and coordination among a credit institution's credit risk staff, financial reporting staff, senior management, the management body and others who are involved in the credit risk assessment and ECL measurement process. This should be evidenced by written policies and procedures, management reports and minutes of committees involved such as management body or senior management committees; and
- d. an internal audit⁹ function that:
- i. independently evaluates the effectiveness of the credit institution's credit risk assessment and measurement systems and processes, including the credit risk rating system; and
 - ii. makes recommendations on addressing any weaknesses identified during this evaluation.

4.2.2 Principle 2 — Sound ECL methodologies

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 and result

⁹ Article 74 of Directive 2013/36/EU and EBA Guidelines on Internal Governance (GL 44).

in the appropriate and timely recognition of ECL in accordance with the applicable accounting framework.

28. 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.
29. Credit institutions should, to the maximum extent possible, leverage and integrate common processes, systems, tools and data that are used within a credit institution to determine if, when, and on what terms, credit should be granted; monitor credit risk; and measure allowances for both accounting and capital adequacy purposes.
30. A credit institution's allowance methodologies should clearly document the definitions of key terms related to the assessment of credit risk and ECL measurement (such as loss and migration rates, loss events and default). Where different terms, information or assumptions are used across functional areas (such as accounting, capital adequacy and credit risk management), the underlying rationale for these differences should be documented and approved by senior management. Information and assumptions used for ECL estimates should be reviewed and updated as required by the applicable accounting framework.
31. Credit institutions should have in place adequate processes and systems to appropriately identify, measure, evaluate, monitor, report and mitigate the level of credit risk. During the transition to the ECL accounting model, existing processes and systems should be evaluated and, if necessary, modified to collect and analyse relevant information affecting the assessment of credit risk and ECL measurement.
32. Credit institutions should adopt and adhere to written policies and procedures detailing the credit risk systems and controls used in their credit risk methodologies, and the separate roles and responsibilities of the credit institution's management body and senior management.
33. Sound methodologies for assessing credit risk and measuring the level of allowances (subject to exposure type, for example retail or wholesale) should, in particular:
 - a. include a robust process that is designed to equip the credit institution with the ability to identify the level, nature and drivers of credit risk upon initial recognition of the lending exposure, to ensure that subsequent changes in credit risk can be identified and quantified;
 - b. include criteria to duly consider the impact of forward-looking information, including macroeconomic factors. Whether the evaluation of credit risk is conducted on a collective or individual basis, a credit institution should be able to demonstrate that this consideration has occurred so that the recognition of ECL is not delayed. Such criteria should result in the identification of factors that affect repayment, whether related to borrower incentives, willingness or ability to perform on the contractual obligations, or lending exposure terms and conditions. Economic factors considered (such as unemployment rates or occupancy rates)

should be relevant to the assessment and, depending on the circumstances, this may be at the international, national, regional or local level;

- c. include, for collectively evaluated exposures, a description of the basis for creating groups of portfolios of exposures with shared credit risk characteristics;
- d. identify and document the ECL assessment and measurement methods (such as a loss rate method, probability of default (PD)/loss-given-default (LGD) method, or another method) to be applied to each exposure or portfolio;
- 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. Credit institutions should be able to explain to the competent authorities the rationale for any changes in measurement approach (for example, a move from a loss rate method to a PD/LGD method) and the quantitative impacts of such changes;
- f. document:
 - i. the inputs, data and assumptions used in the allowance estimation process, such as historical loss rates, PD/LGD estimates and economic forecasts;
 - ii. how the life of an exposure or portfolio is determined (including how expected prepayments and defaults have been considered);
 - iii. the time period over which historical loss experience is evaluated;
 - iv. any adjustments necessary for the estimation of ECL in accordance with the applicable accounting framework. For example, if current and forecasted economic conditions are different from those that existed during the historical estimation period being used, adjustments that are directionally consistent with those differences should be made. In addition, a credit institution may have experienced little to no actual losses in the historical period analysed; however, current or forward-looking conditions can differ from conditions during the historical period, and the impact of these changes on ECL should be assessed and measured;
- g. include a process for evaluating the appropriateness of significant inputs and assumptions in the ECL measurement method chosen. The basis for inputs and assumptions used in the process of the estimation of allowances should generally be consistent from period to period. Where the inputs and assumptions or the basis for these change, the rationale should be documented;
- h. identify the situations that would generally lead to changes in ECL measurement methods, inputs or assumptions from period to period (for example, a credit institution may state that a loan that had been previously evaluated on a collective basis using a PD/LGD method may be

- removed and evaluated individually using the discounted cash flow method upon receipt of new, borrower-specific information such as the loss of employment);
- i. consider the relevant internal and external factors that may affect ECL estimates, such as the underwriting standards applied to a lending exposure at origination and changes in industry, geographical, economic and political factors;
 - j. address how ECL estimates are determined (for example historical loss rates or migration analysis as a starting point, adjusted for information on current and expected conditions). A credit institution should have an unbiased view of the uncertainty and risks in its lending activities when estimating ECL;
 - k. identify what factors are considered when establishing appropriate historical time periods over which to evaluate historical loss experience. A credit institution should maintain sufficient historical loss data to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis;
 - 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, reviews and other tasks/processes that are inputs to or outputs from the credit risk assessment and measurement process are performed by competent and well-trained staff and validated by staff who are independent of the credit institution's lending activities. These inputs to and outputs from these functions should be well documented, and the documentation should include clear explanations supporting the analyses, estimates and reviews;
 - o. document the methods used to validate models for ECL measurement (for example backtests);
 - p. ensure that ECL estimates appropriately incorporate forward-looking information, including macroeconomic factors, that has not already been factored into allowances measured on an individual exposure basis. This may require management to use its experienced credit judgement to consider broad trends in the entire lending portfolio, changes in the credit institution's business model, macroeconomic factors, etc.; and
 - q. require a process to assess the overall appropriateness of allowances in accordance with the relevant accounting framework, including a regular review of ECL models.
34. A credit institution's 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. In addition, consideration of credit risk inherent in new products and activities should be a key

part of the credit risk identification process, the assessment of credit risk and measurement of ECL.

35. Senior management should consider relevant facts and circumstances, including forward-looking information, that are likely to cause ECL to differ from historical experience and that may affect credit risk and the full collectability of cash flows.
36. With respect to factors related to the character, capacity and capital of borrowers, the terms of lending exposures, and the values of assets pledged as collateral together with other credit risk mitigants that may affect the full collectability of cash flows, a credit institution should (depending on the type of exposure) consider:
 - a. its lending policies and procedures, including its underwriting standards and lending terms, that were in effect upon initial recognition of the borrower's lending exposure, and whether the lending exposure was originated as an exception to this policy. A credit institution's lending policy should include details of its underwriting standards, and guidelines and procedures that drive the credit institution's lending approval process;
 - b. a borrower's sources of recurring income available to meet the scheduled payments;
 - c. a borrower's ability to generate a sufficient cash flow stream over the term of the financial instrument;
 - d. the borrower's overall leverage level and expectations of changes to leverage;
 - e. the incentives or willingness of borrowers to meet their obligations;
 - f. unencumbered assets¹⁰ the borrower may pledge as collateral in the market or bilaterally in order to raise funds and expectations of changes to the value of those assets;
 - g. reasonably possible one-off events and recurring behaviour that may affect the borrower's ability to meet contractual obligations; and
 - h. timely evaluations of collateral value and consideration of factors that may impact the future value of collateral (bearing in mind that collateral values directly affect estimates of LGD).
37. Where they have the potential to affect the credit institution's ability to recover amounts due, credit institutions should consider factors relating to the credit institution's business model and current and forecasted macroeconomic conditions, including but not limited to:
 - a. competition and legal and regulatory requirements;

¹⁰ Commission Implementing Regulation (EU) 2015/79 of 18 December 2014 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards asset encumbrance, single data point model and validation rules.

- b. trends in the institution's overall volume of credit;
 - c. the overall credit risk profile of the credit institution's lending exposures and expectations of changes thereto;
 - d. credit concentrations to borrowers or by product type, segment or geographical market;
 - e. expectations of collection, write-off and recovery practices;
 - f. the quality of the credit institution's credit risk review system and the degree of oversight by the credit institution's senior management and management body; and
 - g. other factors that may impact ECL including, but not limited to, expectations of changes in unemployment rates, gross domestic product, benchmark interest rates, inflation, liquidity conditions, or technology.
38. 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 their processes to generate relevant scenarios to be used in the estimation of ECL. In particular:
- a. credit institutions should demonstrate and document how ECL estimates would alter with changes in scenarios, including changes to relevant external conditions that may impact ECL estimates or components of the ECL calculation (such as PD and LGD parameters);
 - b. credit institutions should have a documented process for determining the time horizon of the scenarios and, if relevant, how ECL is estimated for exposures whose lives exceed the period covered by the economic forecast(s) used;
 - c. scenarios may be internally developed or outsourced. For internally developed scenarios, credit institutions should have a variety of experts, such as risk experts, economists, business managers and senior management, assisting in the selection of scenarios that are relevant to the credit institutions' credit risk exposure profile. For outsourced scenarios, credit institutions should ensure that the external provider tailors the scenarios to reflect the credit institutions' business and credit risk exposure profile, as credit institutions remain responsible for those scenarios;
 - d. backtesting should be performed to ensure that the most relevant economic factors that affect collectability and credit risk are being considered and incorporated into ECL estimates; and
 - e. where market indicators (such as credit default swaps ('CDS') spreads) are available, senior management may consider them to be a valid benchmark against which to check the consistency of its own judgements.

39. While a credit institution does not need to identify or model every possible scenario through scenario simulations, it should consider all reasonable and supportable information that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL. In developing such estimates for financial reporting purposes, credit institutions should consider the experience and lessons from similar exercises it has conducted for regulatory purposes (although stressed scenarios are not intended to be used directly for accounting purposes). Forward-looking information, including economic forecasts and related credit risk factors used for ECL estimates, should be consistent with inputs to other relevant estimates within the financial statements, budgets, strategic and capital plans, and other information used in managing and reporting within a credit institution.
40. 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 the following fact patterns, which are potentially indicative of inadequate estimates of ECL:
- a. the granting of credit to borrowers based on fragile income streams (that could become non-recurrent upon a downturn) or with no documentation or limited verification of borrower income sources;
 - b. high debt service requirements relative to the borrower's net available expected cash flows;
 - c. flexible repayment schedules, including payment vacations, interest-only payments and negative amortisation features;
 - d. for real estate and other asset based financing, lending of amounts equal to or exceeding the value of the financed property or otherwise failing to provide an adequate margin of collateral protection;
 - e. undue increases in modifications of lending exposures due to financial difficulties faced by the borrower¹¹ or renegotiations/modifications of lending exposures for other reasons (such as competitive pressures faced by credit institutions);
 - f. circumvention of the classification and rating requirements, including rescheduling, refinancing or reclassification of lending exposures;
 - g. undue increases in the volume of credit, especially in relation to the increase in the volume of credit by other lenders in the same market; and
 - h. increasing volume and severity of past-due, low-quality and impaired credit.

¹¹ See also Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 41, 20.2.2015, p. 1) which establishes specific definitions of forbearance and non-performing exposures.

41. Credit institutions' accounting policies should address, and their allowance methodology should include, criteria for (a) renegotiations/modifications of lending exposures due to financial difficulties or for other reasons, considering also the specific definitions of forbearance established in Part 2 of Annex V of Commission Implementing Regulation (EU) 680/2014 and (b) the treatment of purchased or originated credit-impaired lending exposures as defined under the applicable accounting framework:
- a. Credit institutions should take into account the following criteria regarding renegotiations/modifications of lending exposures:
 - i. The allowance methodology should enable credit institutions to perform a robust assessment of credit risk and measurement of ECL such that the allowance level continues to reflect the collectability of the substance of the renegotiated/modified exposure, irrespective of whether or not the original asset is derecognised under the applicable accounting framework.
 - ii. Renegotiations/modifications should not automatically lead to the conclusion that there has been an immediate decrease in the credit risk of the exposure. Any decrease in the reported allowance level due to improved credit risk should be supported by strong evidence. Customers should demonstrate consistently satisfactory payment performance over a reasonable period of time before credit risk would be considered to have decreased, considering also the relevant requirements for exposures in the probation period as defined in Part 2 of Annex V of Commission Implementing Regulation (EU) 680/2014.
 - iii. Credit institutions should carefully consider whether the collection of loan principal is reasonably assured when repayment performance takes the form of interest payments alone, subsequent to a renegotiation or modification. In addition, further expected delays in the payment of those cash flows may evidence that credit risk has not improved, and thus the level of ECL should be reassessed carefully.
 - iv. 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. For more complex renegotiations and modifications, regular communication between the lending staff and the accounting function should take place.
 - b. Credit institutions should take into account the following criteria regarding purchased or originated credit-impaired lending exposures:
 - i. The methodology should enable appropriate identification and accounting for purchased or originated credit-impaired lending.

- ii. The cash flow estimates for these lending exposures should be reviewed each reporting period and updated as necessary. Such updates should be properly supported and documented, and approved by senior management.

4.2.3 Principle 3 — Credit risk rating process and grouping

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

42. As part of its credit risk assessment process, credit institutions should have in place 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 that may manifest themselves over time, in order to reasonably ensure that all lending exposures are properly monitored and that ECL allowances are appropriately measured.
43. The credit risk rating process should include an independent review function. Initial assignment of credit risk grades to exposures and their ongoing updating by front-line lending staff should be subject to the review of the independent review function.
44. Credit institutions should take into account a number of criteria when assigning the credit risk grade upon initial recognition of a lending exposure including, to the extent relevant, product type, terms and conditions, collateral type and amount, borrower characteristics and geography or a combination thereof.
45. When changing existing credit risk grades assigned, on either a portfolio or an individual basis, credit institutions should take into account other relevant factors such as, but not limited to, changes in industry outlook, business growth rates, consumer sentiment and changes in economic forecasts (such as interest rates, unemployment rates and commodity prices) as well as weaknesses in underwriting identified after initial recognition.
46. The credit risk rating system should capture all lending exposures when assessing the impact of changes in credit risk, and not only those that may have experienced significant increases in credit risk, have incurred losses or are otherwise credit impaired. This is to allow for an appropriate differentiation of credit risk and grouping of lending exposures within the credit risk rating system, and to reflect the risk of individual exposures as well as, when aggregated across all exposures, the level of credit risk in the portfolio as a whole. In this context, an effective credit risk rating system should allow credit institutions to identify both migration of credit risk and significant changes in credit risk.
47. Credit institutions should 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 (i.e. the independent review function).

48. Credit risk grades should be reviewed whenever relevant new information is received or a credit institution's expectation of credit risk has changed. Credit risk grades assigned should receive a periodic formal review (for example at least annually, or more frequently if required in a jurisdiction) to reasonably ensure that those grades are accurate and up to date. Credit risk grades for individually assessed lending exposures that are higher risk or credit impaired should be reviewed more frequently than annually. ECL estimates should be updated on a timely basis to reflect changes in credit risk grades for either groups of exposures or individual exposures.

Grouping based on shared credit risk characteristics

49. Credit institutions should group exposures with shared credit risk characteristics in a way that is sufficiently granular to be able to reasonably assess changes in credit risk and thus the impact on the estimate of ECL for these groups.
50. A credit institution's methodology for grouping exposures to assess credit risk (such as by instrument type, product terms and conditions, industry/market segment, geographical location or vintages) should be documented and subject to appropriate review and internal approval by senior management.
51. Lending exposures should be grouped according to shared credit risk characteristics so that changes in the level of credit risk respond to the impact of changing conditions on a common range of credit risk drivers. This includes considering the effect on the group's credit risk in response to changes in forward-looking information, including macroeconomic factors. The basis of grouping should be reviewed by senior management to ensure that exposures within the group remain homogeneous in terms of their response to credit risk drivers and that the relevant credit risk characteristics and their impact on the level of credit risk for the group have not changed over time.
52. Exposures should not be grouped in such a way that an increase in the credit risk of particular exposures is obscured by the performance of the group as a whole.
53. Credit institutions should have in place a robust process to ensure appropriate initial grouping of their lending exposures. Subsequently, the grouping of exposures should be re-evaluated and exposures should be re-segmented if relevant new information is received or a credit institution's changed expectations of credit risk suggest that a permanent adjustment is warranted. If a credit institution is not able to re-segment exposures on a timely basis, a temporary adjustment should be used.

Use of temporary adjustments

54. Credit institutions should use temporary adjustments to an allowance only as an interim solution, in particular in transient circumstances or when there is insufficient time to appropriately incorporate relevant new information into the existing credit risk rating and modelling process, or to re-segment existing groups of lending exposures, or when lending exposures within a group of lending exposures react to factors or events differently than initially expected.
55. Such adjustments should not be continuously used over the long term for a non-transient risk factor. If the reason for the adjustment is not expected to be temporary, such as the emergence of a new risk driver that has not previously been incorporated into the institution's allowance methodology, the methodology should be updated in the near term to incorporate the factor that is expected to have an ongoing impact on the measurement of ECL.
56. The use of temporary adjustments requires the application of significant judgement and creates the potential for bias. In order to avoid the creation of potential for bias, temporary adjustments should be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes.

4.2.4 Principle 4 — Adequacy of the allowance

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.

57. Credit institutions should implement sound credit risk methodologies with the objective that the overall balance of the allowance for ECL is developed in accordance with the applicable accounting framework and adequately reflects ECL within that framework.
58. When assessing the adequacy of the allowances credit institutions should take into account relevant factors and expectations at the reporting date that may affect the collectability of remaining cash flows over the life of a group of lending exposures or a single lending exposure. 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, that are relevant to the exposure(s) being evaluated (for example retail or wholesale) in accordance with the applicable accounting framework.
59. Depending on the ability to incorporate forward-looking information into the ECL estimate, credit institutions may use individual or collective assessment approaches; regardless of the assessment approach used, they should be consistent with the relevant accounting requirements and not result in materially different allowance measurements. Together, individual and collective assessments form the basis for the allowance for ECL.
60. The ECL assessment approach used should be the most appropriate in the particular circumstances, and typically should be aligned with how the credit institution manages the

lending exposure. For example, collective assessment is often used for large groups of homogeneous lending exposures with shared credit risk characteristics, such as retail portfolios. Individual assessments are often conducted for significant exposures, or where credit concerns have been identified at the individual loan level, such as watch list and past due loans.

61. Regardless of the assessment approach it uses (individual or collective), a credit institution should ensure this does not result in delayed recognition of ECL.
62. When credit institutions use individual assessments, the ECL estimate should always incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, that affect collectability and credit risk. When applying an individual assessment approach, in the same manner as in the case of collective assessment, the credit institution's documentation should clearly demonstrate how forward-looking information, including macroeconomic factors, has been reflected in the individual assessment.
63. In cases when a credit institution's individual assessments of exposures do not adequately consider forward-looking information, and in order to allow identification of relationships between forward-looking information and ECL estimates that may not be apparent at the individual level, an institution should group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors. Conversely, when credit institutions determine that all reasonable and supportable forward-looking information has been incorporated in the individual assessment of ECL, an additional forward-looking assessment should not be conducted on a collective basis if that could result in double counting.

4.2.5 Principle 5 — ECL model validation

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

64. Credit institutions may use in the ECL assessment and measurement process models and assumption-based estimates for risk identification and measurement, at both the individual lending exposure and overall portfolio levels, including credit grading, credit risk identification, measurement of ECL allowances for accounting purposes, stress testing and capital allocation. Models used in the ECL assessment and measurement process should consider the impact of changes to borrower and credit risk-related variables such as changes in PDs, LGDs, exposure amounts, collateral values, migration of default probabilities and internal borrower credit risk grades based on historical, current, and reasonable and supportable forward-looking information, including macroeconomic factors.
65. 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 processes and the estimation of all relevant risk components, at the outset of model usage and on an ongoing basis. Such policies and procedures should appropriately include the role of professional judgement.

66. Model validation should be conducted when the ECL models are initially developed and when significant changes are made to the models, and should ensure that the models are suitable for their proposed usage on an ongoing basis.
67. A sound model validation framework should include, but not be limited to, the following elements:
 - a. Clear roles and responsibilities for model validation with adequate independence and competence. Model validation should be performed independently of the model development process and by staff with the necessary experience and expertise. The findings and outcomes of model validation should be reported in a prompt and timely manner to the appropriate level of authority. Where a credit institution has outsourced its validation function to an external party, the credit institution remains responsible for the effectiveness of all model validation work and should ensure that the work done by the external party meets the elements of a sound model validation framework on an ongoing basis.
 - b. An appropriate model validation scope and methodology should include 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. An effective model validation process should also enable potential limitations of a model to be identified and addressed on a timely basis. The scope for validation should include a review of model inputs, model design and model outputs/performance.
 - *Model inputs:* Credit institutions should have internally established quality and reliability standards on data (historical, current and forward-looking information) used as model inputs. Data used to estimate ECL allowances should be relevant to the credit institutions' portfolios and, as far as possible, accurate, reliable and complete (i.e. without exclusions that could bias ECL estimates). Validation should ensure that the data used meet these standards.
 - *Model design:* For model design, validation should assess that the underlying theory of the model is conceptually sound, recognised and generally accepted for its intended purpose. From a forward-looking perspective, validation should also assess the extent to which the model, at the overall model and individual risk factor level, can take into consideration changes in the economic or credit environment, as well as changes to portfolio business profile or strategy, without significantly reducing model robustness.
 - *Model output/performance:* Credit institutions should have internally established standards for acceptable model performance. Where performance thresholds are

significantly breached, remedial actions up to the extent of model re-calibration or re-development should be taken.

- c. Comprehensive documentation of the model validation framework and process. This should include documenting the validation procedures performed, any changes in validation methodology and tools, the range of data used, validation results and any remedial actions taken where necessary. Credit institutions should ensure that the documentation is regularly reviewed and updated.
- d. A review of the model validation process by independent parties (e.g. internal or external parties) to evaluate the overall effectiveness of the model validation process and the independence of the model validation process from the development process. The findings of the review should be reported in a prompt and timely manner to the appropriate level of authority (e.g. senior management, audit committee).

4.2.6 Principle 6 — Experienced credit judgement

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.

- 68. Credit institutions should have the necessary tools to ensure a robust estimate and timely recognition of ECL. Given that information on historical loss experience or the impact of current conditions may not fully reflect the credit risk in lending exposures, credit institutions should use their experienced credit judgement to thoroughly incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, on its estimate of ECL. A credit institution's use of its experienced credit judgement should be documented in the credit institution's credit risk methodology and subject to appropriate oversight.
- 69. Historical information provides a useful basis for the identification of trends and correlations needed to identify the credit risk drivers for lending exposures. However, ECL estimates must not ignore the impact of (forward-looking) events and conditions on those drivers. The estimate should reflect the expected future cash shortfalls resulting from such impact.
- 70. 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, unless the additional cost and operational burden to be introduced do not contribute to a high-quality implementation of an ECL accounting framework.
- 71. 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. Given that it may not be possible to demonstrate a strong link in formal statistical terms between certain types of information, or even the information set as a

whole, and the credit risk drivers, credit institutions should use their experienced credit judgement 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.

72. Macroeconomic forecasts and other relevant information should be applied consistently across portfolios where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way. Furthermore, when developing ECL estimates, credit institutions should apply their experienced credit judgement to consider their point in the credit cycle, which may differ across the jurisdictions in which they have lending exposures.
73. 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).
74. Additionally, credit institutions should avail themselves of a wide range of information derived in 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.

4.2.7 Principle 7 — Common processes, systems, tools and data

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 expected credit losses.

75. 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 in order to strengthen the reliability and consistency of the resulting ECL estimates, increase transparency and, through market discipline, provide incentives to follow sound credit risk practices.
76. 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 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.
77. The common processes, systems, tools and data mentioned above could include credit risk rating systems, estimated PDs (subject to appropriate adjustments), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payment requirements, market segment, geographical location, vintage (i.e. date of origination) and collateral type.

4.2.8 Principle 8 — Disclosure

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

78. The objective of public disclosures is to provide decision-useful information on a credit institution's financial position and performance, and changes therein, to a wide range of users in a clear and understandable manner. Credit institutions should aim to 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.
79. Financial and credit risk management disclosures should be made in accordance with the applicable accounting and supervisory frameworks¹². Credit institutions should provide the disclosures needed to fairly depict a credit institutions's exposure to credit risk, including its ECL estimates, and to provide relevant information on a credit institution's underwriting practices.
80. Consistently with the applicable accounting standards and regulations, credit institutions' senior management should apply judgement to determine the appropriate level of aggregation and disaggregation of data disclosed, such that disclosures continue to meet accounting requirements, and provide insights into a credit institution's exposure to credit risk and ECLs for users to perform individual institution analysis and relevant peer group comparisons.
81. Quantitative and qualitative disclosures when taken as a whole should communicate to users the main assumptions/inputs used to develop ECL estimates. Disclosures should highlight policies and definitions that are integral to the estimation of ECL (such as a credit institution's basis for grouping lending exposures into portfolios with similar credit risk characteristics and its definition of default¹³), factors that cause changes in ECL estimates, and the manner in which senior management's experienced credit judgement has been incorporated. Disclosure of significant policies should indicate how those policies have been implemented in the specific context of the credit institution.
82. Credit institutions should provide qualitative disclosures on how forward-looking information, including macroeconomic factors, has been incorporated into the ECL estimation process, in accordance with the applicable accounting framework, in particular when the assessment is carried out on an individual basis.

¹²In accordance with Part 8 of Regulation (EU) 575/2013, EBA GL/2016/11 on disclosures requirements under Part 8 of Regulation (EU) 573/2013 and EBA GL/2014/14 on materiality, proprietary and confidentiality and on disclosure frequency under Articles 432(1), 432(2) and 433 of Regulation (EU) No 575/2013.

¹³See paragraphs 89 and 90 in the next section for further guidance on definition of default.

83. Disclosures regarding the basis for grouping lending exposures should include information on how senior management satisfies itself that lending exposures are appropriately grouped, such that these groups continue to share credit risk characteristics.
84. To improve the quality and meaningfulness of information disclosed for ECL estimates, credit institutions should provide an explanation of significant changes to the estimation of ECL from period to period. This information should include both relevant qualitative and quantitative disclosures in a manner that enhances the understanding of how ECL estimates have changed.
85. Credit institutions' 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. In doing so, credit institutions should provide disclosures that facilitate comparisons with its peers, enabling users to monitor changes in the credit institution's ECL estimates from period to period and perform meaningful analyses across national and international peer groups.

4.3 Guidelines specific to credit institutions applying IFRS 9

This section provides guidelines on aspects of the ECL requirements in the impairment sections of IFRS 9 — (i) the loss allowance at an amount equal to 12-month ECL; (ii) the assessment of significant increases in credit risk; and (iii) the use of practical expedients — that are not common to other ECL accounting frameworks and should be read in conjunction with the other sections of these guidelines.

4.3.1 Loss allowance at an amount equal to 12-month ECL

86. In accordance with paragraph 5.5.5 of IFRS 9, 'if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses'. Credit institutions should measure ECL for all lending exposures and a nil allowance should be rare because ECL estimates are a probability-weighted amount that should always reflect the possibility that a credit loss will occur (see paragraphs 5.5.17 and 5.5.18 of IFRS 9). A nil allowance could however occur, for example, for fully collateralised loans (although credit institutions should be cautious when developing estimates of collateral value, as valuation of collateral at origination may change over the life of the loan).
87. Credit institutions should adopt an active approach to assessing and measuring 12-month ECL that enables changes in credit risk to be identified in a timely manner and hence the timely recognition of those changes in ECL. In accordance with Principle 6, estimates of the amount and timing of 12-month ECL should reflect senior management's experienced credit judgement, and represent an unbiased probability-weighted estimate of ECL by considering a range of possible outcomes

88. IFRS 9 defines an amount equal to 12-month ECL as ‘the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date’¹⁴. For these purposes, credit institutions must note that an amount equal to the 12-month ECL is not only the losses expected in the next 12 months; rather, in accordance with IFRS 9, paragraph B5.5.43, 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. Credit institutions must also note that, in accordance with IFRS 9, paragraph 5.5.9, to assess whether a financial instrument should move to a lifetime ECL measure, the change in the risk of a default occurring over the expected life of the financial instrument must be considered. In some circumstances, IFRS 9 allows changes in the risk of a default occurring over the next 12 months to be used to make this assessment; however, this may not always be appropriate, and particular attention should be given to the examples set out in IFRS 9, paragraph B5.5.14.
89. IFRS 9, paragraph B5.5.37, does not define default, but requires credit institutions to define default in a manner consistent with that used for internal credit risk management. IFRS 9, paragraph B5.5.37, also includes a rebuttable presumption that default does not occur later than 90 days past due. When adopting a definition of default for accounting purposes, credit institutions should be guided by the definition used for regulatory purposes provided in Article 178 of Regulation (EU) 575/2013¹⁵, which includes both:
- a. a qualitative criterion by which ‘the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security’ (‘unlikeliness to pay’ events); and
 - b. an objective indicator where ‘the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries’, equivalent to the rebuttable presumption in IFRS 9, paragraph B5.5.37.
90. In accordance with Article 178(1) of Regulation (EU) 575/2013, a default event shall be considered to have occurred with regard to a particular obligor when either of the criteria in paragraphs 4(a) and (b) is met, or both are met. In this context, credit institutions should identify default, in accordance with the ‘unlikeliness to pay’ criterion of the debtor, before the exposure becomes delinquent with the 90-days-past-due criterion. In line with the approach followed for regulatory purposes, the list of elements provided in Article 178(3) of Regulation (EU) 575/2013 as indications of unlikeliness to pay should be implemented in a way that ensures a timely detection of ‘unlikeliness to pay’ events that precipitate eventual cash shortfalls. As regards the criterion in paragraph 4(b), although for regulatory purposes in the case of retail and public sector entity obligations, for the 90-day figure competent authorities

¹⁴ See IFRS 9, Appendix A, Defined terms.

¹⁵ The EBA has published draft Guidelines on the application of the definition of default in accordance with Article 178 of Regulation 575/2013.

may substitute a figure of up to 180 days for different products, as it considers appropriate to local conditions (see Article 178(1)(b) of Regulation (EU) 575/2013), this possibility should not be read as an exemption from the application of the 90-day rebuttable presumption in IFRS 9, paragraph B5.5.37, for those exposures.

91. In formulating the estimate of the amount equal to 12-month ECL, credit institutions should consider reasonable and supportable information, as referred to in the Definitions and in Principle 6 of these guidelines, that affect credit risk, especially forward-looking information, including macroeconomic factors. Credit institutions should exercise experienced credit judgement to consider both qualitative and quantitative information that may affect the credit institution's assessment of credit risk. IFRS 9 provides that an entity does not need to undertake an exhaustive search for information when measuring an amount equal to 12-month ECL. However, credit institutions should actively incorporate information that may affect the estimate of ECL, and credit institutions should not exclude or ignore relevant information that is reasonably available.
92. Where a credit institution originates high-credit-risk exposures (which should not be understood, in the context of this paragraph, as meaning the opposite of 'low credit risk' exposures as described by IFRS 9, paragraph 5.5.10) and their allowances are initially measured at 12-month ECL, the credit institution should monitor these exposures closely for significant increases in credit risk to ensure a timely movement of the exposure to lifetime ECL measurement, in order to take into account that high risk exposures are likely to exhibit greater volatility and to experience a more rapid increase in credit risk.
93. 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. Such adjustments should be made well before exposures move, either individually or collectively, to lifetime ECL measurement and taking into account any migration of credit risk which has taken place.
94. Where a collective assessment is performed, exposures within that group should adhere to the requirements set out in Principle 3 of these guidelines. In particular, where information becomes available to the credit institution indicating 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 or, in the case of transient circumstances, a temporary adjustment should be applied (see Principle 3 of these guidelines and its detailed requirements on the use of temporary adjustments). Where information becomes available which indicates that a particular subgroup has suffered a significant increase in credit risk, then lifetime ECL should be recognised in respect of that subgroup.
95. Lending exposures should not be grouped in such a way as to obscure the identification of significant increases in credit risk on a timely basis (see also Principles 3 and 4 of these guidelines for additional requirements regarding grouping and collective assessments of ECL).

4.3.2 Assessment of significant increases in credit risk

96. IFRS 9, paragraph 5.5.4, states that ‘the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.’
97. The rationale for this approach is that the creditworthiness of the counterparty, and thus the ECL anticipated upon initial recognition, is taken into account in the pricing of credit at that time. It follows, then, that a post-origination increase in credit risk may not be fully compensated by the interest rate charged, and, as a consequence, credit institutions should carefully consider whether there has been a significant increase in credit risk¹⁶. If so, the lending exposure should be subject to lifetime ECL measurement.
98. In order to consider whether an exposure has suffered a significant increase in credit risk and the measurement of required 12-month ECL and lifetime ECL, credit institutions should have in place sound governance, systems and controls, in accordance with the principles specified in these guidelines. Unless already established, credit institutions should implement systems that are capable of handling and systematically assessing the large amounts of information that will be required to judge whether or not particular lending exposures or groups of lending exposures exhibit a significant increase in credit risk, and to measure lifetime ECL where that is the case. Parent undertakings and subsidiaries subject to Directive 2013/36/EU should ensure that the approach is consistent across the group. 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. The need for consistency should not be interpreted as a requirement that the practice be identical across a group. On the contrary, within a consistent framework there may be differences across jurisdictions and products, depending for instance on the availability of data. These differences should be well documented and justified.
99. Credit institutions’ processes in place should enable them to determine on a timely and holistic basis whether there has been a significant increase in credit risk subsequent to the initial recognition of a lending exposure so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to lifetime ECL measurement as soon as credit risk has increased significantly, in accordance with the IFRS 9 impairment accounting requirements.

¹⁶ IFRS 9 requires entities to consider a wide range of factors in assessing for significant increases in credit risk, and pricing may be one of those factors.

100. As noted in paragraph B5.5.17 of IFRS 9 on assessing significant increases in credit risk since initial recognition, the range of information that will need to be considered in making this determination is wide. In broad terms, it will include information on macroeconomic conditions, and the economic sector and geographical region relevant to a particular borrower or a group of borrowers with shared credit risk characteristics, in addition to borrower-specific strategic, operational and other characteristics. A critical feature is the required consideration of all reasonable and supportable forward-looking information that is available without undue cost and effort (see also paragraph 131 of these guidelines on the information set to be used), in addition to information about current conditions and historical data.
101. In order to recognise allowances on a timely basis in line with the IFRS 9 requirements, credit institutions should:
- a. assemble data and forward projections for the key drivers of credit risk in their lending exposures and portfolios; and
 - b. be able to quantify the credit risk in each of their lending exposures or portfolios based on these data and projections.
102. IFRS 9, paragraph B5.5.2, states that lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due and that ‘typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed’. Therefore, credit institutions’ analyses should take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Credit institutions should be mindful that delinquency data are generally backward-looking, and will seldom on their own be appropriate in the implementation of an ECL approach. For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes will generally lead to an increase in the level of credit risk long before this manifests itself in lagging information such as delinquency.
103. Thus, in order to meet the objective of IFRS 9 in a robust manner, credit institutions 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, 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.
104. Credit institutions should perform analyses of this kind not only in the context of portfolios of individually small credits, such as credit card exposures, but also for large,

individually managed lending exposures. For example, for a large commercial property loan, credit institutions should take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and consider using information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.

105. Credit institutions should have a clear policy including well-developed criteria on what constitutes a 'significant' increase in credit risk for different types of lending exposures. Such criteria and the reasons why these approaches and definitions are considered appropriate should be disclosed in accordance with IFRS 7 *Financial Instruments: Disclosures*, paragraph 35F. IFRS 9, paragraph 5.5.9, requires that, when making the assessment of significant increases in credit risk, 'an entity shall use the change in the risk of default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses'. For these purposes, institutions should make this assessment in terms of the risk of a default occurring and not expected credit loss (i.e. before consideration of the effects of credit risk mitigants such as collateral or guarantees).
106. In developing their approach to determining a significant increase in credit risk, credit institutions should consider each of the 16 classes of indicators in IFRS 9 (insofar as they are relevant to the financial instrument being assessed) as set out in paragraphs B5.5.17(a)-(p) and, in addition, credit institutions should consider whether there is further information that should be taken into account. Such indicators (in both IFRS 9 and these guidelines) should not be viewed as a 'checklist'. Some may be more relevant than others to assessing whether a particular type of lending exposure exhibits a significant increase in credit risk. At the same time, credit institutions should take particular care to avoid the risk of a significant increase in credit risk not being acknowledged promptly when it is, in fact, present. In particular, 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 impairment requirements). Rather, debtors may exhibit a significant increase in credit risk without evidence that the related lending exposures are likely to become impaired. The fact that credit risk has increased significantly does not necessarily mean that default is probable — merely that it is more likely than at initial recognition. This point is underlined by the symmetry of the IFRS 9 model: it is possible for lending exposures to move to lifetime ECL but subsequently be moved back to 12-month ECL if the threshold of a significant increase in credit risk is no longer met.
107. Credit institutions should consider in particular the following non-exhaustive list of indicators in assessing a significant increase in credit risk:
- a. a decision by the credit institution's senior management such that, if an existing lending exposure were newly originated at the reporting date, the element of the price of the lending exposure that reflects the credit risk of the exposure would be significantly higher than it was when the loan was actually originated, because of an increase in the credit risk of the specific borrower or class of borrowers since inception;

- b. a decision by the credit institution's senior management to strengthen collateral and/or covenant requirements for new lending exposures that are similar to lending exposures already originated, because of changes in the credit risk of those exposures since initial recognition;
- c. a downgrade of a borrower by a recognised credit rating agency, or within a credit institution's internal credit rating system;
- d. for performing lending exposures subject to individual monitoring and review, an internal credit assessment summary/credit-quality indicator that is weaker than upon initial recognition;
- e. deterioration of relevant determinants of credit risk (e.g. future cash flows) for an individual obligor (or pool of obligors); and
- f. expectation of modification due to financial difficulties, including those qualifying as forbearance in accordance with Regulation (EU) 2015/227.

While implementation of IFRS 9 should reflect credit risk management practices where possible, in some cases that would not be appropriate. If, for example, a credit institution manages most lending exposures in the same way regardless of credit risk — with the exception only of particularly strong or weak credits — the manner in which a lending exposure is managed is unlikely to be a sound indicator of whether there has been a significant increase in credit risk.

108. When assessing whether there has been a significant increase in credit risk for a lending exposure, credit institutions should also take into account the following factors which are related to the environment in which a credit institution or the borrower operates:
- a. deterioration of the macroeconomic outlook relevant to a particular borrower or to a group of borrowers. Macroeconomic assessments should be sufficiently rich to include factors relevant to sovereign, corporate, household and other types of borrower. Furthermore, they should address any relevant regional differences in economic performance within a jurisdiction¹⁷; and
 - b. deterioration of prospects for the sector or industries within which a borrower operates.

109. Accurate identification of drivers of credit risk, and reliable demonstration of the linkages between those drivers and the level of credit risk, should be considered as critical, as a seemingly small change in a qualitative characteristic of a loan can potentially be a leading indicator of a large increase in the risk of a default occurring. Furthermore, in accordance with IFRS 9, paragraph 5.5.9, the significance of a change in credit risk since initial recognition

¹⁷ See Principle 6 of these guidelines on the consideration of forward-looking information, including macroeconomic factors.

depends on the risk of a default occurring at initial recognition. In this regard, where a credit institution uses changes in PD as a means of identifying changes in the risk of a default occurring, it should take into consideration the significance of a given change in PD expressed in a ratio (or the rate of fluctuation) proportionate to the PD at initial recognition (i.e. a change in the PD divided by the PD at initial recognition), considering also paragraph B5.5.11 of IFRS 9. However, the width of the change in PD itself (i.e. PD at measurement date minus PD at initial recognition) should also be taken into consideration.

110. Credit institutions should look beyond how many 'grades' a rating downgrade entails because the change in PD for a one-grade movement may not be linear (for example, the default probability over five years of an exposure rated BB is around three times that of one rated BBB, based on current data and analyses applicable to certain jurisdictions). Furthermore, because the significance of a one-grade movement would depend on the granularity of a bank's rating system — and hence the 'width' of each grade — an appropriate initial segmentation should be defined to ensure that a significant increase in credit risk for an individual lending exposure or a group of lending exposures is not obscured within a segment. In this regard, credit institutions should ensure that credit risk rating systems include a sufficient number of grades to appropriately distinguish credit risk. Credit institutions should also be mindful of the fact that a significant increase in credit risk could occur prior to a movement in a credit grade.
111. Credit institutions should take into account that there are some circumstances in which an adverse movement in the factors listed in paragraphs 107 and 108 above might not be indicative of a significant increase in credit risk. For example, it may be the case that the default probability of a lending exposure rated AA is low, and not much greater than one rated AAA. However, very few lending exposures are of such apparently low credit risk — and, as noted in paragraph 110, the sensitivity of default probability to rating grades may increase strongly as rating quality declines.
112. Credit institutions should also be aware that there could be circumstances in which some factors move in an adverse direction but may be counterbalanced by improvement in others (see IFRS 9 Implementation Guidance, Example 2). Nonetheless, in view of the importance of detecting whether there has been a significant increase in credit risk, credit institutions should put in place governance and control processes capable of reliably validating any judgement that factors which may have an adverse impact on credit risk are counterbalanced by factors which may have a favourable impact.
113. Credit institutions should give thorough consideration and full weight to discretionary decisions by a credit institution's management body or senior management which point to a change in credit risk. For example, if because of concerns about credit risk a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken by the decision-maker had the increase in credit risk not been perceived as significant.

114. 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 — for example, because of differences in the timing of when lending was provided — it should ensure that all lending exposures are identified where there has been a significant increase in credit risk.
115. Where a credit institution makes the assessment of significant increases in credit risk on a collective basis (i.e. such as retail), 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. Changing economic conditions may require regrouping.
116. In line with paragraph B5.5.1 of IFRS 9 on the assessment of significant increases in credit risk since initial recognition on a collective basis, in instances where it is apparent that, within a group of lending exposures, some lending exposures have experienced a significant increase in credit risk, credit institutions should transfer a subset or a proportion of the group of lending exposures to lifetime ECL measurement even though it is not possible to identify this on an individual lending exposure basis (see IFRS 9, Illustrative Example 5).
117. Consistent with paragraph B5.5.6 of IFRS 9 and paragraph IE39 of the Implementation Guidance for IFRS 9, if it is not possible on the basis of shared credit risk characteristics to identify a particular subgroup of lending exposures for which credit risk has increased significantly, an appropriate proportion of the overall group should be subject to lifetime ECL measurement.
118. ‘Significant’ should not be equated with statistical significance, meaning that the assessment approach should not be based solely on quantitative analysis. For portfolios which have a large number of individually small credits, and a rich set of relevant historical data, it may be possible to identify ‘significant’ increases in credit risk in part by using statistical techniques. However, for other lending exposures, that may not be feasible.
119. ‘Significant’ should also not be judged in terms of the extent of impact on a credit institution’s primary financial statements. Identification and disclosure of significant increases in credit risk should be undertaken, even where an increase in credit risk defined in terms of probability of default is unlikely to affect the allowance made — for example, because the exposure is more than fully collateralised — to allow credit institutions to identify and disclose such increases which are likely to be important to users seeking to understand trends in the intrinsic credit risk of a credit institution’s lending exposures.
120. In accordance with IFRS 9, paragraph 5.5.9, the assessment of significant increases in credit risk is based on comparing credit risk on exposures at the reporting date relative to credit risk upon initial recognition. IFRS 9, paragraph BC 5.161, and Illustrative Example 6 represent an example of the application of this principle in the Standard, rather than an exception to that principle. This example suggests that credit institutions can set a maximum credit risk for particular portfolios upon initial recognition that would lead to that portfolio

moving to lifetime ECL measurement when credit risk increases beyond that maximum level. This simplification is only relevant when exposures are segmented on a sufficiently granular basis such that a credit institution can demonstrate that the analysis is consistent with the principles of IFRS 9. Specifically, credit institutions should be able to demonstrate that a significant increase in credit risk had not occurred for items in the portfolio before the maximum credit grade was reached.

121. 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.
122. Credit institutions should be alert to any possibility of bias being introduced that would prevent the objectives of IFRS 9 from being met. In cases where credit institutions believe that their approach to implementation is likely to have introduced bias, they should change their assessment for identified bias and thus ensure that the objective of the Standard is met (see in particular IFRS 9, paragraphs B5.5.1-B5.5.6).
123. IFRS 9, in paragraphs 5.5.12 and B5.5.25-B5.5.27, sets out the requirements for the assessment of significant increases in credit risk for lending exposures whose contractual cash flows have been renegotiated or modified. In particular, for modifications that do not result in derecognition in accordance with IFRS 9, an entity must assess whether credit risk has increased significantly by comparing (a) the risk of a default occurring at the reporting date based on the modified contractual terms with (b) the risk of default occurring upon initial recognition based on the original, unmodified contractual terms.
124. Credit institutions 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.
125. When determining whether there is a significant increase in credit risk for a modified lending exposure, credit institutions should be able to demonstrate, and should take into account when developing ECL estimates, whether such modifications or renegotiations have improved or restored the ability of the credit institution to collect interest and principal payments compared with the situation upon initial recognition. Consideration should also be given to the substance of modified contractual cash flows as well as the implications of the modifications for the future credit risk of the lending exposure (taking into consideration the obligor's credit risk). Factors to consider include, but are not limited to, the following:
 - a. whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, compared with the original, unmodified contractual terms, and how the modification economically affects the obligor's ability to repay the debt;

- b. whether factors can be identified that support a credit institution's assessment of the obligor's ability to repay the debt, including circumstances leading up to the modification, and future prospects of the obligor as a result of the modifications, considering current conditions, macroeconomic forecasts, and prospects for the sector/industry within which the obligor operates, the obligor's business model, and the obligor's business (management) plan that outlines the obligor's expectations of its future performance, financial resilience and cash flows; and
- c. whether the obligor's business plan is feasible, realisable and consistent with the repayment schedule of interest and principal under the modified contractual terms of the lending exposure.

126. Lending exposures transferred to lifetime ECL that are subsequently renegotiated or modified, and not derecognised, 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 compared with that upon initial recognition. For example, where a credit institution grants various concessions such as interest rate reductions or postponements of principal repayments to obligors in financial difficulty, the lending exposure may exhibit characteristics of a lower credit risk even though in reality the obligor may continue to experience financial difficulty with no realistic prospects of making scheduled repayments over the remaining term of the exposure. In accordance with paragraph B5.5.27 of IFRS 9 'evidence that the criteria for the recognition of lifetime ECL are no longer met could include a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms'.

4.3.3 Use of practical expedients

- 127. IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies in recognition of the fact that IFRS 9 will be used by a variety of entities, including entities outside the banking industry.
- 128. The paragraphs below address the following practical expedients: the information set which an entity must consider in measuring ECL; the exception for 'low' credit risk exposures; and the 30-days-past-due rebuttable presumption.
- 129. Credit institutions should make limited use of those practical expedients as they have the potential to introduce significant bias and because — given their business — the cost of obtaining the relevant information is not likely to involve 'undue cost or effort'. Credit institutions should consider the need to make adjustments when using practical expedients to avoid any resulting bias, as they should take into account that the objective of IFRS 9 is to

estimate expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (IFRS 9, paragraph 5.5.17).

130. Where a credit institution uses such practical expedients, justifications for the use of practical expedients should be clearly documented by the credit institution.

The information set

131. IFRS 9, paragraph B5.5.15, states that 'an entity shall consider reasonable and supportable information that is available without undue cost and effort' and that 'an entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition'. Credit institutions should not read these statements restrictively and 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. 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.

'Low credit risk' exemption

132. In accordance with paragraph 5.5.10 of IFRS 9, 'an entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have a low credit risk at the reporting date'. Although credit institutions thus have the option for 'low credit risk' exposures not to assess whether credit risk has increased significantly since initial recognition, use of this exemption should be limited. In particular, credit institutions should conduct timely assessment of significant increases in credit risk for all lending exposures.
133. In that context, credit institutions should always recognise changes in 12-month ECL through the allowance where there is not a significant increase in credit risk and move lending exposures to lifetime ECL measurement, if there is a significant increase in credit risk. In order to achieve a high-quality implementation of IFRS 9, any use of the low-credit-risk exemption should be accompanied by clear 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.
134. To illustrate the meaning of low credit risk in IFRS 9, paragraph B5.5.22, IFRS 9, paragraph B5.5.23, cites as an example an instrument with an external 'investment grade' rating. However, all lending exposures that have an 'investment grade' rating from a credit rating agency cannot automatically be considered low credit risk. Credit institutions should rely primarily on their own credit risk assessments in order to evaluate the credit risk of a lending exposure, and not rely solely or mechanically on ratings provided by credit rating agencies (where the latter are available). Nevertheless, optimistic internal credit ratings, as

compared with external ratings, should require additional analysis and justification by a credit institution's management body or senior management.

More-than-30-days-past-due rebuttable presumption

135. Credit institutions should have credit risk assessment and management processes in place to ensure that significant credit risk increases are detected well ahead of exposures becoming past due or delinquent. Although the use of the more-than-30-days-past-due rebuttable presumption as a backstop measure is not precluded in accordance with IFRS 9 alongside other, earlier indicators for assessing significant increase in credit risk, credit institutions should avoid using it as a primary indicator of transfer to lifetime ECL.
136. 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 risk¹⁸. Such analysis should consider both current and reasonable and supportable forward-looking information that may cause future cash shortfalls to differ from historical experience.
137. In this regard, credit institutions should use relevant forward-looking information that is reasonable and supportable to analyse whether there is any substantive relationship between such information and credit risk drivers. Credit institutions should not use the 30-days-past-due rebuttable presumption unless they have demonstrated that the forward-looking information had no substantive relationship with the credit risk driver or such information is not available without undue cost or effort.
138. In the limited instances where past-due information is the best criterion available to a credit institution to determine when exposures should move to the lifetime ECL category, credit institutions should pay particular attention to their measurement of 12-month ECL allowance to ensure that ECL are appropriately captured in accordance with the measurement objective of IFRS 9. Moreover, credit institutions should take into account that significant reliance on backward-looking information will introduce bias into the implementation of an ECL accounting model and that they should ensure that the objectives of the IFRS 9 impairment requirements (i.e. to reflect ECL that meet the stated measurement objectives and to capture all significant increases in credit risk) are met.

¹⁸ For example, in some jurisdictions it is common practice for borrowers to delay repayment for certain exposures, but history shows that those missed payments are fully recouped in the succeeding months.

4.4 Supervisory evaluation of credit risk practices, accounting for expected credit losses and capital adequacy

4.4.1 Principle 1 — Credit risk management assessment

Competent authorities should periodically evaluate the effectiveness of a credit institution's credit risk practices.

139. Competent authorities should be satisfied that credit institutions have adopted and adhered to the sound credit risk practices described in these guidelines. Competent authorities' evaluation should include, but not be limited to, whether:

- a. the credit institution's internal credit risk review function is robust and encompasses all lending exposures;
- b. the quality of a credit institution's processes and systems for identifying, classifying, monitoring and addressing changes in credit risk for all lending exposures in a timely manner is adequate, and management's experienced credit judgement considers current conditions and forward-looking information, including macroeconomic factors, and is well documented;
- c. the credit institution's processes reflect the risk appetite of the credit institution in a manner that ensures lending exposures on which credit risk has increased since origination or purchase to a level in excess of the credit institution's risk appetite are promptly identified and properly monitored, and ECL allowance estimates appropriately reflect the increases in the credit risk of these exposures as increases are identified. Where a credit institution originates or purchases a lending exposure on which credit risk at acquisition exceeds the institution's risk appetite and which therefore represents an exception to the institution's lending policies and standards, competent authorities should evaluate whether the institution has established and adheres to appropriate processes and controls for: the initial identification, review, approval and documentation of such exposures; the reporting of such policy exceptions to senior management and, for individually significant exposures, to the management body; and the proper monitoring of such exposures after initial recognition. Competent authorities should also evaluate whether the credit institution's processes and controls separately identify ECL allowance estimates related to exposures consistent with the credit institution's risk appetite and those related to riskier lending exposures;
- d. appropriate information about the credit risk of lending exposures, changes in credit risk, the related ECL allowance and changes in allowance estimates is provided to the credit institution's management body and senior management on a regular (for example, quarterly or, if warranted, more frequent) basis;
- e. forecasts included in credit risk assessments and measurements are not only reasonable and supportable, but are also consistent with forecasts used for other purposes by the credit institution, all of which are made available to competent authorities; and

- f. the credit institution's policies and procedures for validating the accuracy and consistency of its internal credit risk assessment models are robust.

140. In making these evaluations, competent authorities may require credit institutions to provide supplemental information, not publicly disclosed, through regular supervisory reporting, ad hoc reporting or on-site examinations. Competent authorities could also use these approaches for obtaining supplemental information when performing the evaluations called for in the principles below.

4.4.2 Principle 2 — ECL measurement assessment

Competent authorities should be satisfied that the methods employed by a credit institution to determine accounting allowances lead to an appropriate measurement of ECL in accordance with the applicable accounting framework.

141. In assessing the methods employed by a credit institution to estimate allowances, competent authorities should be satisfied that the credit institution is following policies and practices consistent with the ECL measurement principles outlined in these guidelines, including, but not limited to, the following:

- a. the procedures used by a credit institution to measure ECL are robust and timely and take into account criteria such as updated valuations of credit risk mitigants (and, in particular, collateral, the residual risk after taking into account the mitigants, the correlation of that risk with borrowers' creditworthiness and the potential impact in terms of the effectiveness of protection), cash flow estimates based on assessments of borrower-specific factors and current and future macroeconomic conditions, together with other relevant forward-looking information that affects the expected collectability of the credit institution's lending exposure;
- b. the framework and methodology for establishing allowances, whether determined collectively or individually, are robust;
- c. aggregate allowances on lending exposures are appropriate in accordance with relevant accounting requirements and in relation to the credit risk exposure in the credit institution's portfolio;
- d. uncollectability is recognised in the appropriate period through allowances or write-offs; and
- e. regardless of the method used to determine ECL, the credit institution's internal processes for measuring ECL take account of the credit risk that the credit institution has taken on and changes in the credit risk of the credit institution's lending exposures.

142. Competent authorities should scrutinise the use of practical expedients referred to in section 4.3 to determine the appropriateness of ECL measurement.

143. Competent authorities may make use of the work performed by internal and external auditors in reviewing a credit institution's credit risk assessment and ECL measurement functions¹⁹.

4.4.3 Principle 3 — Capital adequacy assessment

Competent authorities should also consider a credit institution's credit risk practices when assessing a credit institution's overall capital adequacy.

144. In assessing the appropriateness of the level of allowances for lending exposures as an element of a credit institution's overall capital adequacy, competent authorities should look at their credit risk practices and take into account that the credit institution's related ECL processes, methodology and underlying assumptions require the exercise of a substantial degree of experienced credit judgement.

145. In performing their assessments, competent authorities should consider whether a credit institution has:

- a. maintained 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;
- b. analysed all significant relevant factors that affect credit risk and the collectability of the portfolio; and
- c. established an acceptable allowance estimation process that, at a minimum, meets the principles set out in these guidelines, including the relevant accounting requirements.

146. When assessing capital adequacy, competent authorities should consider how a credit institution's accounting and credit risk assessment policies and practices affect the measurement of the credit institution's assets and earnings and, therefore, its capital position.

147. Where competent authorities identify deficiencies when assessing a credit institution's credit risk practices, they should consider how these deficiencies affect the level of reported allowances and, if the aggregate amount of allowances is not appropriate under the applicable accounting framework, the competent authority should discuss this with the credit institution's senior management and management body and take further appropriate supervisory action when necessary.

148. In particular, to the extent that credit risk assessment or ECL measurement deficiencies are significant or are not remedied on a timely basis, competent authorities should consider

¹⁹ EBA Guidelines on Internal Governance (GL44) and EBA Guidelines on communication between competent authorities and statutory auditors (EBA/GL/2016/05)



imposing additional own funds requirements pursuant to Article 104 under Section III, Chapter 2, Title VII of Directive 2013/36/EU.