Box 2.5

RISK COVERAGE THROUGH IFRS 9 OVERLAYS

One of the objectives set by the European Central Bank (ECB) in its supervisory priorities for 2024 was to strengthen credit risk management.[1] In this area, supervisory activity continued along the same lines, with a new thematic review of loan loss provisions, as a follow-up to the review carried out in 2023.

Thus, in 2024, the ECB conducted an exercise to ascertain whether institutions were taking certain risk factors into account in their loan loss provisions, recognised in accordance with International Financial Reporting Standard 9 Financial Instruments (IFRS 9). Another purpose of this review was to understand the use of adjustments to loan loss accounting models, the procedure for calculating these adjustments and the governance of the process.

The results and main conclusions of this review were published in July 2024 in the report *IFRS 9 overlays and model improvements for novel risks*.[2]

First, the ECB identified a number of factors affecting credit risk, which it called "novel risks": climate change, high interest rate environment, high inflation, geopolitical instability, energy price rises and supply chain disruptions.

These risks are characterised by the limited capacity of traditional loan loss provisioning models to capture them, due to the lack of historical data on them. Consequently, in order to incorporate these risks adequately into their loan loss provisions, institutions need to make changes to their methodologies. Thus, it is common for them to make adjustments to their models, either to the data or to the model output. These adjustments are commonly referred to as "overlays".

Once these novel risk factors had been identified, the ECB collected information from 53 significant institutions on these factors and on overlays, which enabled it to identify best practices in this area. In addition, the ECB was able to assess each institution's progress with respect to the review carried out in 2023 and thus have a measurement of supervisory effectiveness.

The main conclusions published by the ECB in its report were:

- Institutions show improvements in the incorporation of novel risk factors into their expected loan loss provisions in comparison to the 2023 review. Of particular note is the improvement in the consideration of climate and environmental risk, which is now taken into account by 55% of institutions in the exercise.
- The use of overlays, provided they are based on robust analyses and subject to strong governance, is fundamental to incorporating risks that are not adequately captured by traditional models into estimates of loan loss provisions.
- Institutions must continue to pay attention to governance. Although the majority of institutions have processes in place to identify novel risks and determine the necessary overlays, approximately half still lack clear allocation of responsibilities or robust review mechanisms.
- Although the ECB acknowledges that, in general, progress has been made, it continues to observe certain limitations in the design and implementation of overlays:
  - The practices employed do not always allow for the differentiation of impacts and of the sectors or customer groups most exposed to each risk.
  - In certain cases, a generic overlay is recorded to cover a wide range of risks; a practice that does not allow for an assessment of whether each risk is adequately covered.
  - Occasionally, there is an excessive reliance on expert judgement in the quantification of the overlay.
  - The recording of overlays does not always translate consistently into the reclassification of exposures to worse credit quality categories. It should be remembered that when an identifiable risk affects a transaction's default risk, it should also be taken into account when assessing whether reclassification is necessary.

It is worth noting that, although the ECB's work is focussed on the six novel risks mentioned above, its conclusions could be extended to the recording of overlays due to

1 For further details, the supervisory priorities of the Single Supervisory Mechanism for 2024-2026 can be found at the following link.

2 BCE. (2024). *IFRS 9 overlays and model improvements for novel risks. Identifying best practices for capturing novel risks in loan loss provisions.* https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.IFRS9novelrisks_202407~5e0eb30b5c.en.pdf

Box 2.5
RISK COVERAGE THROUGH IFRS 9 OVERLAYS (cont'd.)

other factors that are not adequately considered in loan loss provisioning models or to other limitations of these models.

Lastly, the ECB indicates that it will continue to monitor the most lagging institutions and it even envisages the application of specific supervisory measures in certain cases.