

Overview of Expected Credit Losses

In plain language



IFRS 9 requires the calculation of expected credit losses on financial assets for all financial years starting on or after 1 January 2018.

We have always known that all financial assets carry a risk of not being paid on time and in full. This is known as the credit risk of that asset. We measure this risk by considering the chances of this credit event happening (Probability of Default or PD), the amount that will be owing on the date of the default (Exposure At Default or EAD) and the amount that will not be recovered (Loss Given Default or LGD). IFRS 9 refers to the measurement of the credit risk as Expected Credit Losses (ECL's).

Default is defined as the situation where the risk of non-payment (or part payment) or delayed payment increases significantly and will need to be defined for each organisation. The definition adopted is likely to be a combination of standard criteria (insolvency, inability to pay) and factors appropriate to the context (30, or 60, or 90 days in arrears etc.)

As implied by the name, ECL's are a forward-looking measure. The established methodology to measure a future outcome is through a model that considers past events combined with our expectations of the future conditions in which these events will occur. This is done based on statistical correlations to macroeconomic factors, both past and future.

IFRS 9 does not provide much detail on how ECL's should be measured. Fortunately, the banking industry has been required to perform these calculations for more than a decade for regulatory purposes. This provides us with an established best practice that is tried and tested as well as logical and defensible.

Best practice dictates that different types of models need to be applied to different classes of assets – there is no one size fits all model for measuring credit risk.

For each class of assets, it is necessary to measure a PD, EAD and LGD and then apply a forward-looking view of the economic environment. The calculation of PD is typically performed via a model – different types for various categories of consumer loans, privately owned businesses and listed companies etc. The EAD is usually simple to determine other than in certain classes of loans. The LGD is measured by considering amounts recovered in the normal course of business or a liquidation process taking collateral into account. The time value of money must also be considered as we are dealing with late payment.

To create a model you need a meaningful amount of data and advanced statistical skills. In most instances outside of large financial institutions it will not be possible or affordable to create a bespoke model so there is more than likely going to be a need for an externally created model that is relevant to the circumstances.

We convert these measures to forward looking by incorporating a view on the macro-economic environment.

IFRS 9 sets out that assets of different risk stages require different accounting treatment regarding whether the 1 year or lifetime ECL's apply and the treatment of interest. The measurement of PD will help establish the triggers for allocating an asset to the different stages.



About i9 Partners

i9 Partners provides Expected Credit Loss (ECL) calculations for IFRS 9 through the use of leading tools and credit intelligence. We cover all classes of financial assets with solutions for auditors, smaller companies to large corporates, public sector entities and smaller financial institutions.

We remove the pain of IFRS 9 compliance through access to a range of world class credit models to calculate ECL's and our network of multi-disciplinary partners. Our depth of credit, IFRS and technology skills is unique in the marketplace

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