

A Survey on the Estimation of Expected Credit Losses for IFRS 9

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Extended Abstract

The IASB has introduced a new impairment model for financial instruments in response to the financial crisis of IFRS 9. Since 2018 it has to be tested, whether a financial instrument has experienced a significant increase in credit risk since origination or not (*SICR-test*). If not, an amount equal to the expected credit loss resulting from events within the next 12 months has to be recognized. Otherwise, even a risk provision equal to the expected credit loss over the remaining lifetime has to be recognized.

Although there is a similar expected loss model in the Basel Accords, the requirements of IFRS 9 go beyond them, and require in particular different methods to estimate the probability of default. At the same time, IFRS 9 provides only very broad guidelines on the estimation, and leaves enormous room for discretion. Many contributions have therefore been published on the quantification of expected credit losses for IFRS 9. The present study aims to provide a comprehensive overview of the ongoing discussion about the standard-compliant implementation of the new impairment model, both in practice and academia. In particular, we conduct a systematic literature review of approximately 70 contributions in the English- and German-speaking literature this subject. We structure these contributions and summarize the proposed methods.

We find that all contributions are at least implicitly based on the so-called *credit risk parameter approach*, which splits expected credit losses into the probability of default (PD), the loss given default (LGD) and the exposure at default (EAD). Consequently, we have also structured our con-

tent analysis around these parameters. In line with anecdotal evidence from practice, we find that rating-based models in discrete time are mentioned most often to estimate the PD. Other methods, by contrast, are considered less frequently, although they may often be more suitable. Regarding the estimation of the LGD, no consensus seems to have emerged yet. Controversy also exists over the implementation of the stage allocation, where different benchmarks and scalings are discussed, and the choice of suitable transfer thresholds remains an open matter. Further discussions are related to the use of regulatory models in accounting, the distinction between point-in-time and through-the-cycle parameters, and the feasibility of downturn adjustments.

Informal reviews of banks' disclosures on IFRS 9 indicate that the first the first generation of models used to estimate expected credit losses are rather simple, and there is evidence that expected credit loss estimations for hypothetical borrowers vary significantly across banks, whereby methodological differences are considered to be one of the main drivers (Thakkar 2018). Given the economic importance of the impairment provisions, we anticipate that a comprehensive review of the available estimation options will be useful and relevant not only for academics from the fields of accounting and finance, but also for preparers of financial statements, auditors, standard setters and regulators.