

Expected Credit Losses under IFRS 9



FOREWORD

The introduction of the Expected Credit Loss (ECL) model under IFRS 9 Financial Instruments (IFRS 9) represents a paradigm shift in the way organizations recognize and measure credit impairment. The ECL framework under IFRS 9 mandates that impairment allowances be recognized from the moment a financial asset is originated, with provisions dynamically updated to reflect changes in credit risk over time. This publication aims to guide risk practitioners, preparers, and users of financial statements through the intricacies of ECL measurement and disclosure under IFRS 7 Financial Instruments: Disclosures. It brings together practical insights, illustrative examples, and the latest regulatory perspectives to help navigate the challenges and seize the opportunities presented by IFRS 9. By deepening our understanding of ECL, we can contribute to more resilient financial reporting and informed decision-making in an increasingly uncertain world.

We trust that this resource will serve as a valuable companion on your journey through the evolving landscape and application of the concept of credit risk under IFRS 9.

Thank you

For Uniquis Consultech

Foreword

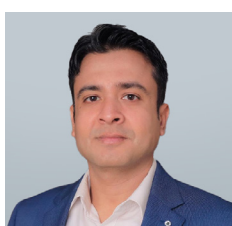
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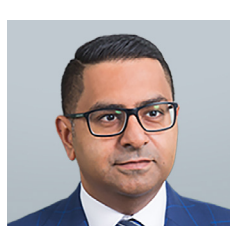
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1. INTRODUCTION

Overview of IFRS 9 and its significance

IFRS 9 Financial Instruments is a standard issued by the International Accounting Standards Board (IASB). It introduces significant changes to the financial reporting landscape, particularly through the Expected Credit Loss (ECL) framework. The ECL model fundamentally shifts impairment recognition from the backward-looking incurred loss approach to a forward-looking methodology. Under IFRS 9, entities must recognize credit losses from the point of initial recognition, considering past events, current conditions, and reasonable and supportable forecasts of future economic scenarios. This ensures more timely and realistic provisioning for credit losses by improving transparency and addressing criticisms that the incurred loss model delayed recognition during economic downturns such as the Global Financial Crisis (GFC) of 2008.

Evolution of IFRS 9

- **2008-09:** Following the GFC, the IASB and the US Financial Accounting Standards Board (FASB) initiated a joint project to overhaul financial instruments accounting, focusing on enhancing transparency and aiming for fair value reporting. In November 2009, the IASB issued the first part of IFRS 9, focusing on classification and measurement of financial assets, thereby replacing parts of IAS 39.
- **2010:** IASB reissued IFRS 9, adding requirements for classification and measurement of financial liabilities, while retaining IAS 39's derecognition rules.
- **2011-13:** Further exposure drafts and additions were made, including hedge accounting rules in 2013, allowing entities to choose between IFRS 9 or IAS 39 hedge accounting.
- **2014:** The complete version of IFRS 9 was published on 24 July 2014, consolidating all components and fully replacing IAS 39 guidance.
- **2016:** The IASB issued amendments to IFRS 4 Insurance Contracts, allowing insurers to defer application of IFRS 9 until the effective date of the new insurance standard (IFRS 17), to mitigate accounting mismatches.
- **2017:** Repayment Features with Negative Compensation (Amendments to IFRS 9) was issued by the IASB to address the concerns about how IFRS 9 classifies particular prepayable financial assets.
- **2018:** IFRS 9 became effective for annual periods beginning on or after 1 January 2018, with early adoption allowed.
- **2020:** The standard was amended by *Annual Improvements to IFRS Standards 2018–2020* (fees in the '10 per cent' test for derecognition of financial liabilities).
- **2021:** IASB issued Initial Application of IFRS 17 and IFRS 9 — Comparative Information (Amendment to IFRS 17) to permit entities that first apply IFRS 17 and IFRS 9 at the same time to present comparative information about a financial asset as if the classification and measurement requirements of IFRS 9 had been applied to that financial asset before.
- **2024:** Amendments to the Classification and Measurement of Financial Instruments (Amendments to IFRS 9 and IFRS 7, Annual Improvement to IFRS Accounting Standards – Volume 11 and Contracts Referencing Nature-dependent Electricity (Amendments to IFRS 9 and IFRS 7) were published.

These developments reflect the IFRS 9 framework's continuous evolution to address practical implementation issues, emerging risks, and sustainability-linked financial instruments.

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2. UNDERSTANDING THE EXPECTED CREDIT LOSS FRAMEWORK

Definition and scope of ECL

The unbiased and probability-weighted amount of credit losses, determined by evaluating a range of possible outcomes. ECL represents the present value of all cash shortfalls, i.e., the difference between the contractual cash flows and the expected cash flows to be received, discounted using the effective interest rate (EIR) determined at initial recognition. The scope of ECL applies broadly to financial assets measured at amortized cost or fair value through other comprehensive income (FVTOCI), lease receivables, loan commitments, and financial guarantees.

Exclusions

While IFRS 9's ECL model has wide applicability, certain instruments or scenarios follow specific guidance or are excluded.

- Financial Instruments Measured at Fair Value Through Profit or Loss (FVTPL): ECL does not apply; their fair value changes are already recognized in profit or loss
- Trade Receivables and Contract Assets: For these, entities can choose to apply a simplified approach where lifetime ECLs are recognized
 - **Without a significant financing component**
Entities must apply the simplified approach, which requires recognizing lifetime ECL from initial recognition, without the need to track changes in credit risk over time. Since there is no significant financing component, the effective interest rate is considered zero, and discounting of expected cash shortfalls is generally not required.
 - **With Significant Financing Component**
Entities can choose between the general approach (three-stage model) or the simplified approach (lifetime ECL). Under the general approach, entities assess whether there has been a significant increase in credit risk since initial recognition and measure ECL as either 12-month or lifetime ECL accordingly. The present value of expected cash shortfalls is discounted using the original effective interest rate, reflecting the time value of money
- Lease Receivables: Similar to trade receivables, entities can apply a simplified approach for lease receivables
- Financial Guarantee Contracts and Loan Commitments: These are included in the scope of the ECL model, but specific guidance is provided on how to measure ECLs for these instruments as follows-
 - ECL for financial guarantee contracts and loan commitments is measured as the present value of expected credit losses over the period of exposure to credit risk. For financial guarantees, this reflects expected payments to reimburse the holder; for loan commitments, it considers expected losses from possible loan drawdowns. In both cases, ECL must be unbiased, probability-weighted, and incorporate all reasonable and supportable information.

This is not discussed further in detail here as it is outside the scope of this publication.
- Short-term Trade Receivables and Contract Assets: For these, entities may not need to consider forward-looking information extensively due to their short-term nature.

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3. THREE-STAGE IMPAIRMENT MODEL

Under IFRS 9, the Expected Credit Loss (ECL) model is structured into a three-stage impairment framework based on the level of deterioration in credit quality since initial recognition.

How are the 3 stages determined?

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Stage 1:

Stage 1: 12-month ECL:

At initial recognition, and for financial instruments where there has not been a significant increase in credit risk since initial recognition, entities recognize 12-month ECL. This represents the portion of lifetime ECLs that result from default events possible within the next 12 months.

Lifetime ECL (Not Credit-Impaired):

If there is a significant increase in credit risk (SICR) since initial recognition but the financial instrument is not yet credit-impaired, entities recognize lifetime ECL. This means recognizing the expected losses over the entire remaining life of the financial instrument.

Stage 2:

Stage 3:

Stage 3: Lifetime ECL (Credit-Impaired):

When a financial instrument becomes credit-impaired, entities continue to recognize lifetime ECL, but interest revenue is calculated based on the net carrying amount (i.e., the gross carrying amount less the loss allowance) rather than the gross carrying amount.

Rebuttable Presumption of Default:

Under IFRS 9, there is a rebuttable presumption that a financial asset becomes credit-impaired and moves to Stage 3 when it is more than 90 days past due. This serves as a default backstop unless there is reasonable and supportable evidence to rebut it. Conversely, even before 90 days past due, an exposure can be considered defaulted based on other qualitative indicators (e.g., bankruptcy, restructuring, or significant deterioration in creditworthiness). Entities must document their rationale when rebutting this presumption, particularly where internal policies or sectoral norms justify deviation from the 90-day threshold.

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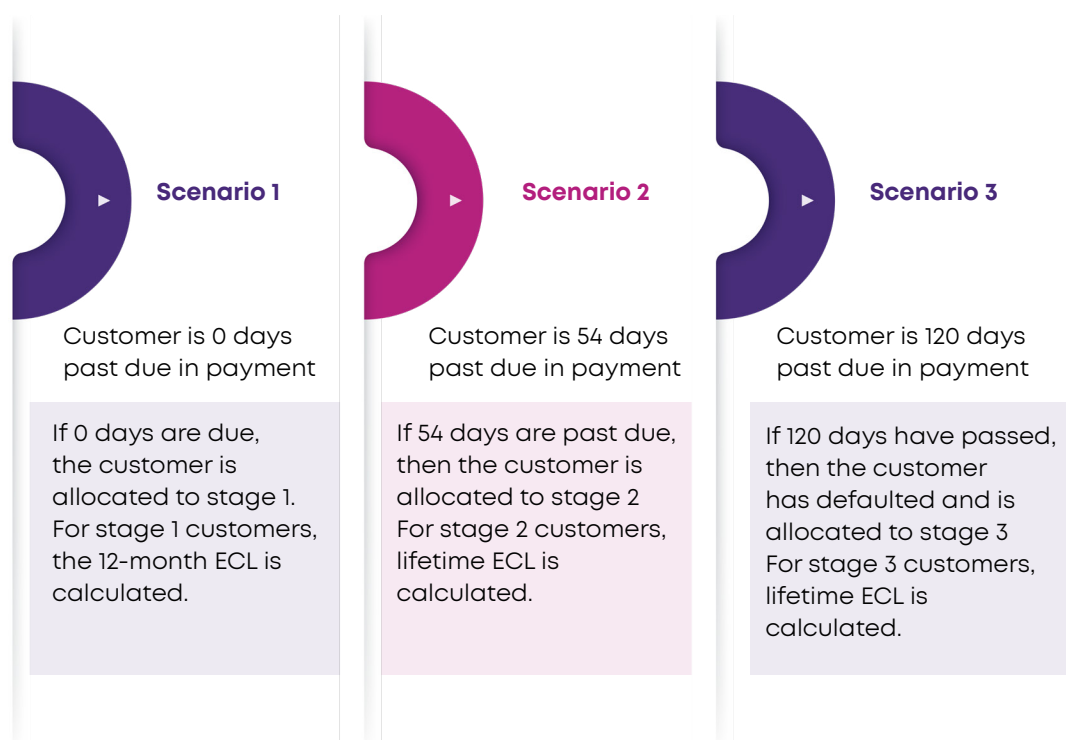
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Action	Stage 1	Stage 2	Stage 3
Credit Risk Status	No significant increase in credit risk (SICR) since initial recognition	Significant increase in credit risk (SICR) but no objective evidence of impairment	Credit-impaired (default is imminent or has occurred)
ECL calculation	12-month ECL (expected losses over next 12 months)	Lifetime ECL (expected losses over full remaining life)	Lifetime ECL
Interest Revenue recognition	Gross amount x EIR	Gross amount x EIR	Net amount x EIR
Reversals possible	N/A	Yes (back to Stage 1)	Yes (to Stage 2 if cured)

Example:

Customer A has a total O/s of \$100,000 with an LGD of 50%, and the exposure at default for this customer is \$ 1,000. The maturity date of the loan is December 2030. What will be the ECL estimate (12-month or lifetime) for this customer in Dec 2020 if:



Criteria for transitioning between stages

Transition from Stage 1 to Stage 2:

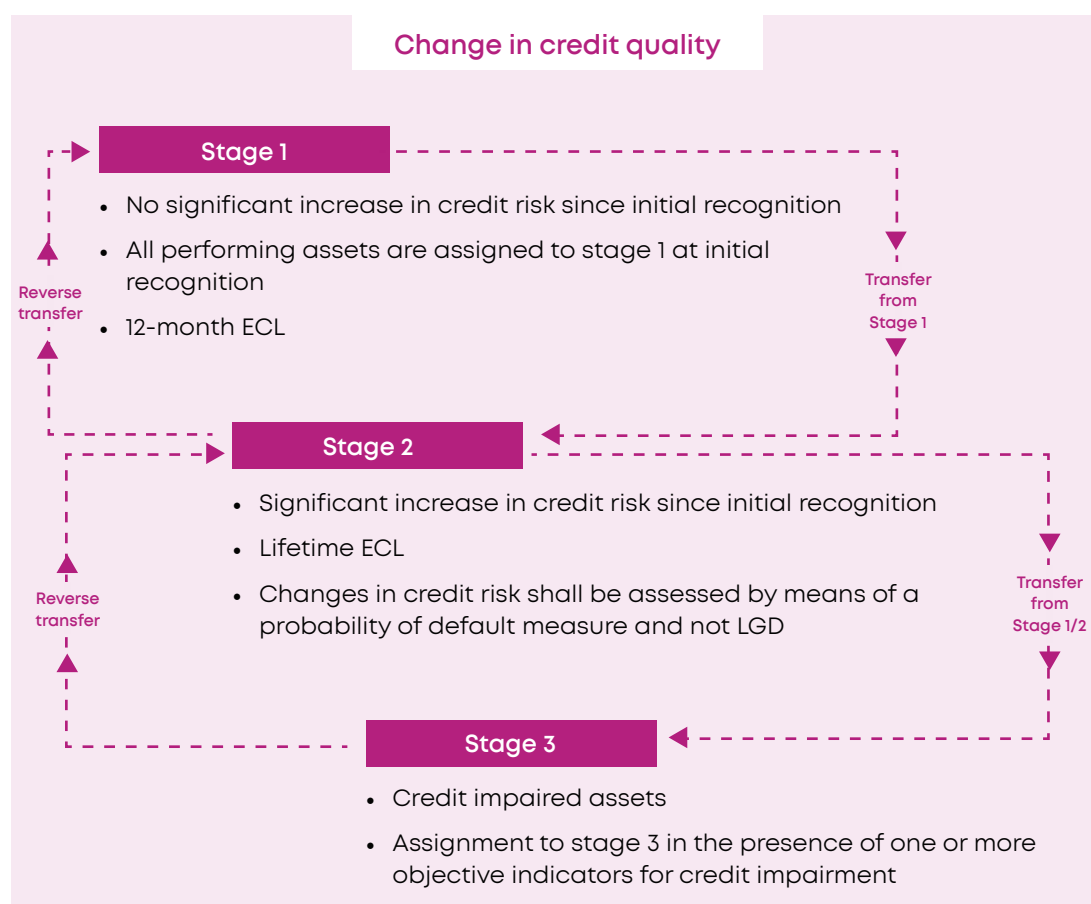
- **Significant Increase in Credit Risk:** A financial asset moves from Stage 1 to Stage 2 when there is a significant increase in credit risk since initial recognition. This is typically assessed using various indicators such as changes in credit ratings, significant changes in the terms of the financial instrument, or adverse changes in the economic environment.
- **Quantitative and Qualitative Factors:** Entities must consider both quantitative factors (e.g., changes in default probabilities) and qualitative factors (e.g., changes in management's expectations) to determine if there has been a significant increase in credit risk.

Transition from Stage 2 to Stage 3:

- **Credit-Impaired Status:** A financial asset moves to Stage 3 when it becomes credit-impaired. This occurs when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred.
- **Indicators of Credit Impairment:** Indicators include significant financial difficulty of the issuer or borrower, a breach of contract (e.g., default or past due status), or the lender granting concessions that it would not otherwise consider.

Reversal of Stages:

- **Improvement in Credit Risk:** If the credit risk of a financial asset improves such that the significant increase in credit risk since initial recognition no longer exists, the asset can move back from Stage 2 to Stage 1.
- **Recovery from Credit-Impaired Status:** If a credit-impaired financial asset shows significant improvement and no longer meets the criteria for being credit-impaired, it can transition from Stage 3 to Stage 2.



4. ECL FRAMEWORK

While IFRS 9 permits flexibility in selecting methodologies, real-world application demands judicious design, calibration, and governance of the ECL model. The standard components—Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD)—are just the starting point. Their interaction with business models, data infrastructure, and regulatory expectations defines the quality of the resulting ECL estimate.

ECL Methodologies: Practice Use Cases

Methodology	Use Case	Insights
General Measurement Model (GMM)	Retail & wholesale loans, bonds	Requires robust credit staging logic and integration with risk systems. Complex to maintain but offers alignment with risk-based pricing and ICAAP.
Simplified Approach	Trade receivables, leases	Operationally efficient. Widely used in telco, FMCG, and real estate. Flow-rate and provision matrix models dominate this space.
Purchased or originated credit-impaired	Distressed asset portfolios, restructured exposures	Requires use of credit-adjusted EIR. In KSA, typically relevant for legacy exposures and high-risk SME segments.

The standard formula for calculating ECL is: $ECL = PD * LGD * EAD$

4.1 Probability of default (PD)

PD represents the probability that a borrower will default within a specified time frame, typically one year. It quantifies the likelihood of default for a financial instrument over a defined period. The term 'multi-year (or lifetime) PDs' refers to a series of PD values corresponding to various time intervals.

PD reflects the credit risk inherent in receivables, loans, or financial exposures, and is a key input to determine ECL. Under IFRS 9, PD must reflect current conditions and reasonable forecasts, making it a forward-looking, point-in-time estimate.

4.1.1 Practical Insights on PD

- In non-financial sectors (e.g., telecom, logistics, utilities), PD estimation is often based on historical flow rates (aging analysis of receivables) or payment scorecards.
- For longer-term contracts (e.g., leasing, construction, B2B services), credit scoring models may incorporate qualitative overlays like customer financials or behavioural trends.
- Sector-specific risk (e.g., cyclical, regulatory risk) often drives PD overlays, especially for portfolios with concentrated exposure.
- Where internal models are limited, entities may apply external ratings or proxy benchmarks, supplemented by judgment.

4.1.2 PD Calculation

If a rating system exists, the multi-year PD profiles are typically estimated in a first step at the rating class level. In the second step, the multi-year PD profiles at the transaction level can be obtained using appropriate *interpolation* techniques.

In general, there are 2 types of PDs:

Through The Cycle (TTC) PD

TTC PD estimates the probability of default over an extended time horizon, typically spanning the entire economic cycle. It mitigates short-term economic fluctuations by accounting for a complete business cycle, encompassing periods of both economic growth and recession.

Point in Time (PiT) PD

PiT PD estimates the probability of default based on current economic conditions and the borrower's present financial health. It is more responsive to short-term changes in the economy and the borrower's situation.

PD can be calculated using various different methods such as Gross flow rate, New flow rate, Application/behaviour scorecard, Internal/external rating-based approach, Pluto Tasche approach, Vasicek single factor model, Markov chain, Weibull model, Credit Index, Super panel hazard model, Asset based Merton model, etc.

Out of all these methods, flow rate is the most commonly used approach for calculating ECL for trade receivables, and it is explained below in detail.

The **Flow Rate Method** for calculating Probability of Default (PD) under IFRS 9 is a practical, data-driven approach primarily used for trade receivables or portfolios where historical transactional data is available. It involves analyzing the movement (or flow) of receivables through various ageing buckets over time to estimate the likelihood that receivables will default.

How the Flow Rate Method Works

- **Tracking Aging Buckets:** Receivables are categorized into aging buckets based on how long they have been outstanding (e.g., 0-30 days, 31-60 days, 61-90 days, 91+ days).
- **Calculating Flow Rates:** The flow rate is the probability that receivables in one aging bucket will move into the next, more delinquent bucket in the subsequent period. For example, the flow rate from 0-30 days to 31-60 days is calculated by observing historical data on how much of the receivables in the 0-30 days bucket aged into the 31-60 days bucket in the next period.
- **Deriving Loss Rates:** The loss rate is derived from the flow rates and represents the probability that receivables in a given bucket will eventually default (often proxied by reaching the 91+ days bucket, which is assumed to represent default or loss). The loss rate is typically calculated as the cumulative probability of flowing into the default bucket.
- **Applying to Exposure:** The calculated PD (loss rate) is then applied to the total exposure (e.g., the outstanding receivables balance at the reporting date) to estimate the ECL.

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Integration of Macroeconomic Variables (MEVs)

In line with IFRS 9's forward-looking principle, entities are required to incorporate macro-economic variables (MEVs) into the estimation of Probability of Default (PD). These variables — such as GDP growth, unemployment rates, interest rates, inflation, and sector-specific indicators — are factored into credit risk models to reflect expected changes in the economic environment. Typically, entities use multiple economic scenarios (e.g., base, upside, downside), assign probability weightings, and model the impact of MEVs on default probabilities through regression techniques or macro-overlay adjustments. This ensures that PDs are responsive to future economic conditions rather than being solely historical. The choice of variables, scenario assumptions, and overlay methodology should be well-documented, justified, and regularly back-tested.

Key Points in Application

- The PD derived from flow rates is conditional on information available at the reporting date. Post-reporting date collections or payments should not reduce the exposure on which PD is applied, as the calculation is based on the balance as of the reporting date.
- The flow rate method produces a historical, point-in-time estimate of default probability, which must need adjustment for forward-looking information as required by IFRS 9.
- The method assumes that the 91+ days bucket represents default, consistent with IFRS 9's rebuttable presumption that a default occurs no later than 90 days past due.
- The flow rate approach is often combined with a provision matrix, where loss rates for each aging bucket are used to calculate expected credit losses by multiplying the exposure in each bucket by the corresponding loss rate.

Illustration:

1. Historical Ageing of Trade Receivables (\$ million)

Month	Current (Not Due)	0-30 Days	31-60 Days	61-90 Days	91-120 Days	>120 Days
Mar-24	1,000	950	850	700	600	900
Feb-24	980	920	820	680	570	870
Jan-24	950	890	800	650	550	800
Dec-23	930	860	770	620	530	750
Nov-23	910	830	740	600	500	720
Oct-23	900	800	720	580	480	700
Sep-23	880	780	700	550	470	680
Aug-23	860	760	680	530	460	660
Jul-23	840	740	660	510	450	640
Jun-23	820	720	640	500	440	620
May-23	800	700	620	480	420	600
Apr-23	780	680	600	460	400	580

2. Computation of Flow Rates

We calculate how much moved into the next bucket compared to the opening balance.

Example for Current → 0–30 days:

$$\text{Flow Rate} = \frac{\text{Next Month's 0-30 Balance}}{\text{This Month's Current Balance}}$$

Flow From	Example (Feb)	Calculation	Flow Rate (%)
Current → 0-30 days	Feb 0-30 (920) / Jan Current (950)	920/950	96.8%
0-30 → 31-60 days	Feb 31-60 (820) / Jan 0-30 (890)	820/890	92.1%
31-60 → 61-90 days	Feb 61-90 (680) / Jan 31-60 (800)	680/800	85.0%
61-90 → 91-120 days	Feb 91-120 (570) / Jan 61-90 (650)	570/650	87.7%
91-120 → >120 days	Feb >120 (870) / Jan 91-120 (550)	870/550	158% (Cap at 100%)

Note: Repeat for every month, then take the average across 12 months

3. Average Flow Rates (over 12 months)

Movement	Avg Flow Rate (%)
Current 0-30	95%
0-30 → 31-60	90%
31-60 → 61-90	85%
61-90 → 91-120	80%
91-120 → >120	100%

4. Loss Rate Computation

Loss Rate = Product of Flow Rates till default

Bucket	Loss Rate Calculation	Loss Rate (%)
Current	95% x 90% x 85% x 80% x 100% = 58%	58%
0-30 Days	90% x 85% x 80% x 100% = 61%	61%
31-60 Days	85% x 80% x 100% = 68%	68%
61-90 Days	80% x 100% = 80%	80%
91-120 Days	100%	100%
>120 Days	100% (full LGD)	100%

4.1 ECL Computation (Based on Closing Balances - Mar 24)

Ageing Bucket	Balance (₹mn)	Loss Rate	ECL (₹mn)
Current (Not Due)	1,000	58%	580
0–30 Days	950	61%	579.5
31–60 Days	850	68%	578.0
61–90 Days	700	80%	560.0
91–120 Days	600	100%	600.0
>120 Days	900	100%	900.0
Total	5,000		3,797.5

Final Result

Total ECL to recognize = ₹3,797.5 million

Key Process /steps in Summary for calculating ECL using flow rate analysis:

Sl.No.	Step	Descriptions/ Details
1	Historical Ageing	Took 12 months receivables across buckets
2	Flow Rate Computation	% migrated from one bucket to next
3	Loss Rate Computation	Cumulative multiplication of flow rates till default
4	ECL Computation	Loss Rate x Balance of each ageing bucket

4.2 Loss Given Default (LGD)

LGD is the estimated **percentage of loss an organization will incur if a customer, counter-party, or borrower defaults** on a financial obligation. It reflects the portion of the exposure that is **not expected to be recovered**, after considering factors like collateral realization, contractual rights, legal recovery, and any credit enhancements

In an IFRS 9 context, LGD is applied in both 12-month and lifetime ECL calculations and should be **forward-looking**, incorporating expectations of recovery outcomes over time.

LGD quantifies the severity of credit loss, making it a critical component in evaluating credit risk. It's relevance spans:

- Secured receivables (e.g., leases backed by equipment or real estate)
- Service contracts with termination penalties or reconnection costs
- Large trade exposures with customer-specific collateral or guarantees
- Vendor financing, construction milestones, or leasing arrangements

Properly calibrated LGD enables more realistic provisioning and improves the quality of financial reporting and risk management.

How is LGD calculated

The standard method is:

$$\text{LGD} = 1 - \text{Recovery Rate (RR)}$$

where: $\text{RR} = (\text{Net recoveries after default}) / (\text{Exposure at default})$

Example: Customer X borrows a \$200,000 loan from the bank for the purchase of a mortgage. X paid some instalments before it stopped paying further instalments. As the customer defaults, the loan has an outstanding balance of \$100,000. The bank took the mortgage and sold it at \$90,000. What is the LGD value?

LGD is calculated as $\text{LGD} = 1 - \text{Recovery rate}$

Step 1: Calculate the Recovery rate

$$\text{Recovery rate} = \text{Amount received} / \text{Amount lent}$$

Step 2: Calculate LGD

$$\text{LGD} = 1 - (90,000/100,000)$$

$$= (100,000 - 90,000) / 100,000 = 10,000 / 100,000 = 0.1 = 10\%, \text{ Therefore, LGD} = 10\%$$

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4.2.1 Practical Insights across Industries

- In real estate or leasing, recovery depends on market resale value, asset condition, and transaction costs (e.g., liquidation expenses, brokerage).
- In telecom and utilities, LGD may reflect contract enforcement limitations, write-offs of unpaid usage, or the cost of reacquiring customers.
- For industrial or project-based businesses, LGD may be influenced by supply chain disruptions, customer concentration, or project abandonment risk.
- LGD should account for historical recovery experience, but also adjust for forward-looking risks, such as economic conditions, legal delays, or technological obsolescence of underlying assets.
- Credit enhancements like guarantees, retention money, or deposits can reduce LGD, but must be legally enforceable and supported by recovery evidence.

4.3 Exposure at Default (EAD)

Exposure at Default (EAD) refers to the total amount an entity expects to be exposed to when a counterparty or customer defaults. It includes: In telecom and utilities, LGD may reflect contract enforcement limitations, write-offs of unpaid usage, or the cost of reacquiring customers.

- For industrial or project-based businesses, LGD may be influenced by supply chain disruptions, customer concentration, or project abandonment risk.
- LGD should account for historical recovery experience, but also adjust for forward-looking risks, such as economic conditions, legal delays, or technological obsolescence of underlying assets.
- Credit enhancements like guarantees, retention money, or deposits can reduce LGD, but must be legally enforceable and supported by recovery evidence.

EAD quantifies the total financial risk at the point of default and directly influences the ECL. Under IFRS 9, EAD must be estimated across each future period of the exposure's life when calculating lifetime ECL.

It's relevance extends beyond traditional lending into:

- Trade and vendor financing
- Customer credit programs and instalment sales
- Leases, construction receivables, and milestone-based contracts
- Off-balance sheet exposures like performance guarantees, purchase obligations, and undrawn committed facilities

4.3.1 EAD Calculation

The EAD computation depends on the product or contract type:

- On Balance Sheet Items
These include billed receivables, lease instalments, loans, and subscriptions:
 - Use contractual cash flows adjusted for prepayments, cancellations, or churn
 - Consider accrued but unpaid interest or charges
- Off- Balance Sheet Items
These include
 - Undrawn credit lines
 - Letters of credit
 - Performance or financial guarantees
 - Supplier financing or structured payables
 - Such exposures are adjusted using a Credit Conversion Factor (CCF) to estimate likely drawdowns.

$$\text{EAD} = \text{Current Balance} + (\text{Undrawn Amount} \times \text{CCF})$$

EAD modelling basically entails cash flow modelling, a behavioural approach to exposure modelling (when no reimbursement scheme exists), as well as lifetime modelling (when contractual maturity doesn't exist).

4.3.2. Practical Insights across Industries

- Telecom and utilities may have usage-based receivables, and must estimate EAD from postpaid usage before billing.
- Real estate and infrastructure companies may carry off-balance sheet guarantees, warranties, or vendor advances that must be included in EAD.
- Leasing or rental businesses should include future lease instalments, especially for operating leases with non-cancellable periods.
- Retail and fintech lenders often underestimate credit line utilization; behavioural drawdown models offer better accuracy than flat CCFs.
- Corporates issuing performance or financial guarantees must assess historical invocation rates to assign appropriate CCFs.

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5. FORWARD-LOOKING APPROACH IN ECL & CHALLENGES IN THE IMPLEMENTATION OF THE SAME

The forward-looking ECL approach under IFRS 9 represents a paradigm shift in credit risk management by emphasizing early loss recognition based on comprehensive data analysis.

While this approach improves transparency and timeliness in financial reporting, it's implementation poses significant challenges.

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Data Challenges

Institutions must collect extensive internal and external data (e.g., payment history, unemployment rates). Ensuring data quality and accessibility is a major challenge.

1



Model Development

Creating robust models that incorporate historical trends, current conditions, and future forecasts requires advanced expertise in quantitative modelling. Regular calibration is necessary due to changing economic environments.

2



IT Infrastructure

Existing systems often require upgrades to handle complex calculations and large datasets efficiently. Integration of forecasting tools is resource-intensive.

3



Cost Implications

Implementation involves high costs related to system upgrades, staff training, external consulting services, and increased audit requirements.

4



Governance

Effective governance frameworks are needed for scenario selection, model validation, and ensuring compliance with IFRS 9 standards.

5



Cross-Departmental Collaboration

Implementation requires coordination between finance, risk management, IT teams, and external auditors—adding complexity to organizational workflows.

6

6. SECTOR-SPECIFIC CONSIDERATIONS

Sector-specific considerations for ECL under IFRS 9 require a deep understanding of the unique risks and factors affecting each industry, alongside general macroeconomic considerations.

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Financial Institution

- **Loan Commitments and Financial Guarantees:** Financial institutions need to consider the potential drawdowns on loan commitments and the increased probability of default during economic stress. Financial guarantee contracts also require careful assessment as they may exhibit higher risk in periods of economic downturn.
- **Revolving Credit Facilities:** For revolving credit facilities, entities must consider factors like historical exposure to credit risk, the time it takes for defaults to occur after a significant increase in credit risk, and credit risk management actions.

Retail and Consumer Finance:

- **Credit Cards and Consumer Loans:** These sectors often involve revolving credit facilities where customers may frequently draw down and repay balances. The ECL calculation should account for the likelihood of customers failing to pay off future balances, especially if they transition from being transactors to revolvers.

Real Estate and Construction:

- **Property Market Fluctuations:** Changes in property values and rental income can significantly impact the creditworthiness of borrowers in this sector. ECL models should incorporate these market dynamics. However, it is pertinent to note that Property, Plant and equipment will be still impaired under IFRS 36.

Energy and Commodities

- **Price Volatility:** Fluctuations in commodity prices can affect the financial health of companies in these sectors. ECL assessments should consider the impact of price volatility on borrowers' ability to repay debts.

Technology and Telecommunications:

- **Rapid Technological Changes:** The rapid pace of technological advancements can lead to obsolescence and changes in market demand, affecting the creditworthiness of companies in these sectors.

Some of the general considerations across sectors are as follows:

- **Macroeconomic Scenarios:** All sectors should consider macroeconomic conditions and how they might affect credit risk. This includes factors like GDP growth, interest rates, and unemployment levels.
- **Sector-Specific Factors:** Besides macroeconomic scenarios, financial institutions are encouraged to incorporate expected changes in sector-specific factors into their ECL assessments.
- **Regular Review and Documentation:** The methodology for calculating ECL should be regularly reviewed to ensure it remains effective and aligned with actual loss experiences. Documentation of these reviews and any changes to methodologies is crucial.

7. CLIMATE RISK INTEGRATION

Climate-related physical and transition risks can have direct and material implications for credit exposures. Under IFRS 9, entities should consider these risks when estimating Expected Credit Losses (ECL), based on reasonable and supportable information available at the reporting date.

Adjustments to Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD)

Integrating climate risks into ECL models means explicitly adjusting PD, LGD, and EAD components:

ECL Component	Climate Drivers	Modelling Techniques	Practical Implementation Tips
PD	- Revenue disruptions from transitional policies (carbon pricing, regulatory shifts). - Physical hazards (e.g., flooding, heatwaves) reducing borrower viability.	- Integrate climate variables into macroeconomic forecasting models (e.g., GDP adjustments under NGFS scenarios). - Sector-specific stress multipliers based on scenario severity (e.g., higher PD for coal-dependent sectors under stringent carbon pricing).	Begin with high-level sector overlays, such as applying increased PD rates to fossil fuel borrowers facing strict climate policies. Progressively enhance models with specific borrower-level climate metrics, such as location-based flood risk scores, as data availability improves.
LGD	- Reduced collateral values due to climate-driven physical risks (e.g., coastal flooding reducing property values). - Higher recovery costs following extreme climate events.	- Calibrate downturn LGD to reflect increased collateral vulnerability, using property-level hazard mapping (e.g., adjusting LGD upward for properties in flood-prone zones). - Apply haircuts based on projected hazard severity under different climate scenarios.	ECB good practice suggests detailed flood-zone risk assessments to inform precise LGD haircuts for properties in vulnerable locations (e.g., commercial real estate in coastal areas).
EAD	Increased utilization of contingent credit facilities to manage climate impacts or finance transition-related investments.	Stress-based behavioural drawdown models, reflecting increased borrower reliance on contingent lines under severe climate stress scenarios.	Model increased drawdowns specifically for sectors likely to incur significant transition costs, such as heavy industries facing mandatory emissions reductions requiring substantial upfront capital expenditures.

Stage Allocation: Climate as a SICR trigger

Climate-related risk drivers can influence SICR assessment underpinning IFRS 9 stage transitions. Entities may integrate climate-related triggers—such as regulatory changes, carbon taxes, insurance withdrawal, or physical-risk deterioration—where relevant. When quantitative data is insufficient, qualitative overlays with detailed documentation on forward-looking rationale, aligned with regulatory expectations, or leading practices.

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Regulatory Expectations for Climate-ECL Integration

- **EBA Guidelines (2024):** Institutions are encouraged to incorporate climate-related risk drivers into Probability of Default (PD) and Loss Given Default (LGD) assumptions, ensuring robust risk estimation and validation.
- **PRA Thematic Letter (2024):** Firms should strengthen quantitative climate integration within ECL frameworks, moving beyond generalized qualitative overlays. The PRA expects improvements in model methodologies by year-end 2025.
- **ECB Good-Practice Note (2022):** Banks should apply sector-specific climate integration into IFRS 9 models, supported by physical and transition risk scenario analyses to assess financial risks effectively.

Implications for Long-term Provisioning

IFRS 9 impairment horizons are generally limited to the remaining contractual life of financial instruments. Entities may carefully map NGFS (Network for Greening the Financial Sector), IEA (International Energy Agency), or SSP (Shared Socio-economic Pathways) climate scenarios onto these contractually relevant timeframes, emphasizing remaining-tenor-weighted scenario analysis rather than distant scenario endpoints. Where contractually short loan lives prevent direct scenario alignment, entities should apply probability-weighted scenario overlays, clearly documenting the rationale for their “reasonable and supportable” forecast horizon selection.

Data and Governance Next Steps

Given increasing regulatory focus, entities should proactively enhance climate-ECL data capabilities. Institutions are encouraged to develop internal frameworks for collecting and managing critical climate-related data. Immediate data collection efforts should include:

- Borrower-level emissions data
- Detailed physical hazard scores for key assets and collaterals
- Comprehensive borrower-level green capex plans

8. DISCLOSURES REQUIREMENTS FOR ECL UNDER IFRS 7

The transition to IFRS 9 from previous standards like IAS 39 involves significant changes in disclosure practices.

Entities must provide detailed information about how they have applied the new classification and measurement requirements, including *any changes in financial asset classifications and their impact on ECLs*.

The disclosure requirements for ECL under IFRS 9 are designed to enhance transparency and stakeholder understanding by providing detailed insights into credit risk management practices, the measurement of ECLs, and their impact on financial statements. These requirements support more informed decision-making by stakeholders and improve the comparability of financial reporting across entities.

- New Requirements for Transparency
- 1. Credit Risk Management Practices:** Entities must disclose information about their credit risk management practices, including methods used to measure ECLs, assumptions made, and data used in these calculations. This helps stakeholders understand how credit risks are identified and managed.
 - 2. Quantitative and Qualitative Information:** Disclosures must include both quantitative data (e.g., amounts of ECLs recognized) and qualitative explanations (e.g., reasons for changes in ECLs over time). This dual approach ensures that stakeholders can assess both the magnitude and underlying causes of credit losses.
 - 3. Credit Risk Exposure:** Entities are required to disclose information about their credit risk exposure, including significant concentrations of credit risk. This helps stakeholders evaluate the potential impact of credit losses on the entity's financial position.
 - 4. Reconciliation of Loss Allowances:** A reconciliation of movements in loss allowances is necessary to show how ECLs have changed over time. This provides transparency into how credit conditions and management decisions affect provisioning.

- Enhancing Stakeholder Understanding Through Detailed Reporting
- 1. Understanding Financial Position and Performance:** The disclosures under IFRS 9 are designed to enable stakeholders to evaluate the significance of financial instruments for an entity's financial position and performance⁶. By understanding how ECLs are calculated and managed, stakeholders can better assess an entity's financial health.
 - 2. Nature and Extent of Risks:** Detailed reporting helps stakeholders understand the nature and extent of risks arising from financial instruments, both during the reporting period and at the reporting date. This includes insights into how economic conditions and borrower-specific factors influence credit risk.
 - 3. Risk Management Practices:** By disclosing credit risk management practices, entities provide stakeholders with insights into how they manage these risks. This transparency can enhance stakeholder confidence in the entity's ability to navigate challenging credit environments.
 - 4. Comparability Across Entities:** The standardized disclosure requirements under IFRS 9 improve comparability across different entities. This allows stakeholders to compare the credit risk management strategies and outcomes of various companies, facilitating more informed investment decisions.

9. PRACTICAL CONSIDERATIONS FOR ECL IMPLEMENTATION

	Particulars	Requirement	Challenge
Foreword	Data quality and availability	High-quality data is essential for accurate ECL estimation. This includes historical loss data, current credit conditions, and forecasts of future economic conditions	Ensuring data availability and quality, especially for smaller or less granular portfolios.
1. Introduction			
2. Understanding the Expected Credit Loss Framework			
3. Three-Stage Impairment Model	Model complexity and sophistication	Models should be robust enough to capture changing economic conditions and credit risks effectively	Balancing model complexity with practicality and ensuring that models are aligned with existing risk management systems.
4. ECL Framework			
5. Forward-Looking Approach in ECL & Challenges in the Implementation of the Same	Forward-looking approach	Incorporate forecasts of future economic conditions into ECL estimates	Predicting future economic scenarios accurately and updating models to reflect changing conditions.
6. Sector-Specific Considerations	Segmentation and Portfolio Management	Segmentation of portfolios based on credit risk characteristics can help in applying ECL effectively	Identifying appropriate segments and ensuring consistent application across different segments.
7. Climate Risk Integration	Time Value of Money	ECLs must be discounted to the reporting date using the effective interest rate for non-purchased or originated credit-impaired debt instruments	Ensuring that the discounting process accurately reflects the time value of money.
8. Disclosures Requirements for ECL Under IFRS 7			
9. Practical Considerations for ECL Implementation	3 stage of impairment	Managing loans through three stages of impairment: 12-month ECL, lifetime ECL without significant deterioration, and lifetime ECL with significant deterioration	Determining when to transition between stages based on changes in credit risk.
10. Future Trends in ECL Modeling under IFRS 9			
11. Conclusion	Regulatory requirement	Aligning ECL models with regulatory requirements, such as Basel standards	Modifying existing risk management systems to meet both regulatory and accounting standards.

10. FUTURE TRENDS IN ECL MODELLING UNDER IFRS 9

The future of ECL Modelling under IFRS 9 is defined by technological innovation and adaptability. AI-driven solutions are transforming risk assessment processes by improving accuracy, scalability, and efficiency while addressing regulatory challenges through robust governance frameworks. Institutions that invest in these advancements will be better equipped to navigate the complexities of economic uncertainties and stringent compliance requirements.

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Advances in Data Analytics and AI-Driven Risk Models

2. Understanding the Expected Credit Loss Framework

- **Integration of AI and Machine Learning:** Entities must disclose information about their credit risk management practices, including methods used to measure ECLs, assumptions made, and data used in these calculations. This helps stakeholders understand how credit risks are identified and managed.

3. Three-Stage Impairment Model

- **Model Risk Management:** AI models introduce complexities that require robust risk management frameworks. This includes ensuring explainability, transparency, and compliance with regulatory requirements. Tools like Arthur AI's monitoring platform automate reporting and help manage biases or errors in AI models. Centralized model-building processes are being adopted to enhance speed and collaboration among stakeholders during AI model development.

4. ECL Framework

5. Forward-Looking Approach in ECL & Challenges in the Implementation of the Same

- **Improved Data Governance:** High-dimensional data and feature engineering are critical for AI models. Institutions are investing in data governance infrastructure to ensure quality, consistency, and security. This supports the dynamic training of models that adapt to evolving data inputs.

6. Sector-Specific Considerations

- **Adapting to Evolving Economic and Regulatory Landscapes:**

7. Climate Risk Integration

1. **Dynamic Economic Scenarios:** IFRS 9 requires the incorporation of forward-looking macroeconomic scenarios into ECL calculations. Advanced tools now allow institutions to integrate multiple weighted scenarios dynamically, addressing economic uncertainties like inflation or market volatility. The ability to quickly adapt models to reflect changes in economic conditions is becoming a competitive advantage for financial institutions.

8. Disclosures Requirements for ECL Under IFRS 7

2. **Regulatory Compliance:** As regulators closely monitor AI/ML applications in financial services, firms must align their model risk management (MRM) frameworks with supervisory expectations. This includes validating models for compliance, ensuring ethical use of alternative data, and managing risks associated with model opacity. Enhanced disclosures and controls are required under IFRS 9 to capture extensive data for lifetime ECLs and significant credit risk changes.

9. Practical Considerations for ECL Implementation

3. **Flexible Model Design:** Institutions are developing adaptable methodologies that can respond effectively to regulatory changes or economic shifts. This includes designing systems capable of handling both statistical models and expert judgment for low-default asset classes.

10. Future Trends in ECL Modeling under IFRS 9

11. Conclusion

11. CONCLUSION

In conclusion, the adoption of the ECL model under IFRS 9 marks a significant advancement in credit risk management across industries in Saudi Arabia. By emphasizing a forward-looking and data-driven approach, ECL enhances the accuracy and timeliness of loss recognition, promoting greater financial transparency and resilience. While its implementation requires organizations to strengthen their data capabilities and risk assessment processes, the long-term benefits include improved decision-making, enhanced stakeholder confidence, and alignment with global accounting standards. As Saudi Arabia continues to evolve its economic landscape, embracing the ECL framework will be instrumental in fostering sustainable growth and ensuring robust financial health across sectors.

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