BANKING METRICS · EPISODE 10

BANKING METRICS SERIES · CREDIT RISK TOPIC

IFRS 9 STAGING

Stage 1, Stage 2, Stage 3 — how one trigger stretches a provision from the next 12 months to the life of the loan.

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Three Stages, Two Horizons

Every performing loan already carries a provision. The stage decides how far ahead the bank must look.

IFRS 9 assigns every loan a provision from day one and sorts the whole book into three stages. The stage answers one question: do you provision the expected losses of the next 12 months, or those of the loan's entire remaining life?

STAGE 1 12-MONTH ECL	**Performing.** No significant increase in credit risk since origination. The provision covers only the losses linked to a default in the next 12 months. Interest accrues on the gross carrying amount.
STAGE 2 LIFETIME ECL	**Underperforming.** Credit risk has increased significantly since origination (SICR) — but there is no default. The provision now covers the whole residual life.
STAGE 3 LIFETIME ECL	**Credit-impaired.** The loan meets the definition of default. The provision stays lifetime, and interest accrues on the net carrying amount after deducting the provision.

What the two horizons mean

12-month ECL is not the loss of the next 12 months only: it is the lifetime loss weighted by the probability that the default happens within the next 12 months.
Lifetime ECL counts the default risk over the whole residual maturity. Same loan, same LGD, same EAD: what changes is how much of the default probability the bank is forced to recognize.

KEY TAKEAWAY

The step that matters is Stage 1 → Stage 2. The borrower is still paying. What changes is the horizon — from twelve months of risk to a lifetime of it.

What Pushes a Loan into Stage 2?

IFRS 9 never defines "risky". It asks whether risk has increased significantly since the loan was priced.

The principle: compare today with origination

A significant increase in credit risk (SICR) is measured against one benchmark: the default risk the bank expected on the day it originated the loan. A loan born risky can spend its whole life in Stage 1; a loan born very safe can fall into Stage 2 quite soon. What counts is the deterioration, not the absolute level of risk.

SICR test: lifetime PD today vs lifetime PD expected at origination

The triggers banks actually use

- **Quantitative:** the lifetime PD has risen beyond a calibrated threshold versus origination (for example, more than doubled). Each bank sets and documents its own threshold.
- **The backstop criterion —** 30 days past due. At that point the standard presumes a significant increase, unless the bank can rebut it with evidence (IFRS 9 §5.5.11).
- **Qualitative —** forbearance, watch-list entry, sector stress: signals that risk has moved before the models say so..

KEY TAKEAWAY

Stage 2 does not say the borrower is in trouble today. It says the loan is significantly riskier than the day it was originated and the provision must recognize it now.

The Cliff Between Stage 1 and Stage 2

Staging turns a gradual deterioration into a discrete jump in provisions — across the whole book at once.

EU BANKS — END 2020 (EBA)

9.1%

of EU bank loans sat in Stage 2 (up 110bps in a single quarter) while the NPL ratio was falling to 2.6%.

Procyclicality, by design

ECL models are forward-looking: macroeconomic forecasts feed the PDs. When the outlook worsens, lifetime PDs rise and thousands of loans cross their SICR thresholds in the same quarter.
COVID showed it clearly: Stage 2 surged while NPLs were still falling. IFRS 9 books the pain before the default.

The Stage 1–Stage 2 border is where IFRS 9 concentrates its force: one trigger, and the provision jumps from twelve months of risk to a lifetime of it.

This is Episode 10 of the Banking Metrics Series. Each episode takes one key metric, breaks it down from first principles, and illustrates it with real data.