BANKING METRICS SERIES

IFRS 9 ECL

Banks used to book losses only when they happened. IFRS 9 changed everything.

BANKING METRIC SERIES

What Is ECL and why does it hit P&L?

IFRS 9 forces banks to estimate losses before they happen. ECL is not a capital buffer; it charges the income statement every reporting period.

ECL FORMULA

$$ECL = PD \times LGD \times EAD$$

PD — Probability of Default

LGD — Loss Given Default

EAD — Exposure at Default

Weighted across multiple macro scenarios.

WHERE DOES ECL GO?

+ Revenue

– Costs

– ECL Provisions ← here

– Tax

= Net Income

IFRS 9 vs. Basel — same concept, different purpose

Basel uses ECL-like parameters (PD, LGD, EAD) to compute regulatory capital under Pillar 1.
IFRS 9 uses ECL for financial reporting, to measure the carrying value of loans on the balance sheet.
Under IFRS 9, this estimate must be recognized in the income statement every reporting period (loan loss provisions).
The two frameworks apply different models, different time horizons, different assumptions and hence produce different numbers. A bank must run both in parallel.

KEY TAKEAWAY

ECL is not a capital buffer, it is a P&L charge. Basel uses similar parameters for regulatory capital, IFRS 9 uses ECL for accounting. Both run in parallel, both matter.

From Incurred Loss to Expected Loss

Under the previous IAS 39, banks could wait for evidence of loss. IFRS 9 ended that: provisions must now anticipate losses, not confirm them.

IAS 39 — INCURRED LOSS (pre-2018)

Book a loss only when there is objective evidence of impairment: a missed payment, a restructuring, or a default event.

The problem:

In good years, banks delayed recognizing losses, keeping provisions low and profits high. When the cycle turned, provisions surged all at once, amplifying the crisis.

IFRS 9 — EXPECTED LOSS (from 2018)

Recognize losses based on forward-looking expectations, even before any trigger event. Provisions reflect probability-weighted outcomes

The benefit:

Earlier, smoother recognition of credit risk. Less procyclicality, more transparency for investors.

The scope:

IFRS 9 applies to all financial assets at amortized cost or Fair Value through Other Comprehensive Income: loans, bonds, trade receivables, lease receivables, and off-balance-sheet exposures such as undrawn credit lines and financial guarantees. Equities at Fair Value through P&L are excluded.

What changed in practice

IFRS 9 went live in January 2018. Day-one provisions rose significantly across European banks. The COVID-19 shock was the first live test: banks raised provisions in early 2020, ahead of the default peak, exactly as the standard intended.

KEY TAKEAWAY

IAS 39 let banks delay loss recognition. IFRS 9 forces earlier recognition via forward-looking, scenario-weighted provisions, reducing procyclicality and earnings discretion.

How ECL Is Actually Calculated

Unbiased, forward-looking, probability-weighted across macro scenarios, applied across a well-defined portfolio scope.

1 Performing

No significant increase in credit risk since origination.

ECL = 12-month expected loss.

2 Underperforming

Significant increase in credit risk detected.

ECL = lifetime expected loss.

3 Defaulted

Observed default.

ECL = lifetime loss, including interest accrued on net carrying amount.

Three pillars of IFRS 9 methodology

Unbiased: Neither optimistic nor pessimistic. The estimate must reflect all reasonable and supportable information without tilting toward any single scenario.

Forward-looking: Models incorporate macroeconomic forecasts (GDP, unemployment, house prices) into PD and LGD estimates, not just historical averages.

Probability-weighted: ECL calculated as weighted average across scenarios, typically 3 (base, upside, downside) each with an assigned weight.

This is Episode 6 of the Banking Metrics Series.
Each episode takes one key metric, breaks it down from principles, and illustrates it with real data.