What’s the impact on expected credit loss (ECL)?

Under IFRS 9 Financial Instruments, expected credit losses (ECL) are based on reasonable and supportable information that is available without undue cost or effort at the reporting date. This includes information about borrower-specific attributes, past events, current conditions and forecasts of future economic conditions.

Typically, measuring ECL starts with an estimation of borrower-specific (idiosyncratic) risk adjusted for the risks posed by the wider macroeconomic environment (systemic risk). [IFRS 9 B5.5.52, Insights 7.8.230]

In turn, climate-related risks are generally split into two major categories: physical risks (e.g. risks arising from more frequent/severe weather events or from loss of marine diversification); and transition risks (e.g. risks associated with the transition to a less polluting, lower-carbon economy).

Climate-related risks may impact the expected cash flows to be received from a loan and, therefore, the lender’s exposure to credit losses. Borrower-specific attributes, physical risks and transition risks, either individually or in combination, may impact expected cash flows as well as the range of potential future economic scenarios considered in measuring ECL. [IFRS 9.5.5.17(a), Insights 7.8.238]

Getting into more detail

At this time, the impact of climate-related risks on ECL will vary depending on their expected severity and timing, direct and indirect impacts on the borrower and the lender’s loan portfolio, and the duration of the loan portfolio. The impact on ECL today is potentially limited largely because the most significant effects of climate change are expected to emerge over the medium to longer term. However, it is important to monitor the speed and scale of these matters and consider their possible impacts on the measurement of ECL.

Measurement of ECL

The measurement of ECL may be impacted by borrower-specific climate-related risks. For example, the borrower may suffer damage from physical risks such as wildfires, or floods which may negatively affect its ability to repay a loan. The value of any underlying collateral may be impaired by such events – i.e. it may have been damaged or destroyed, or its accessibility or insurability may be reduced. [IFRS 9.A, B5.5.55, Insights 78.240]

Transition risks may impact borrowers who see their business strategies being materially disrupted, leading to higher costs of doing business and reduced
profitability, increased product obsolescence, the potential for stranded assets\(^1\) and loss of market capitalisation – all of which may impact the probability of default (PD) and loss given default (LGD). The impacts on ECL will depend on the timing and severity of these changes compared with the period over which the lender is exposed. Therefore, reasonable and supportable information about the extent to which climate-related risks have either already impacted or are expected to impact the borrower over the life of the loan needs to be considered by the lender in measuring the related ECL.

Lenders may need to consider the impacts of climate-related risks from both a portfolio perspective and a borrower perspective. Climate-related risks will impact each portfolio differently, depending on factors such as industry, geography and duration.

The impact of both physical and transition risks on the wider macroeconomic environment, including macroeconomic variables such as GDP and unemployment rates, is difficult to predict and depends on the severity and timing of such events. The most significant effects of climate change are expected to emerge over the medium to longer term, potentially limiting today’s impact on ECL considering the relatively short-term duration of many bank loan portfolios. Nevertheless, it is important to monitor the speed and scale of these matters and consider their possible impacts.

**Calibration of credit risk models**

As reasonable and reliable quantitative data builds up over time (e.g. flood risk data), this will enable the calibration of credit risk models to factor in the correlation of climate-related risk factors to defaults or anticipated defaults and the resulting impact on PD and LGD.

**Avoid double counting risks**

Investors are also increasingly pricing climate-related risks into credit spreads. Therefore, it is important to avoid double counting risks by considering the extent to which they might already be captured directly or indirectly through ECL model inputs – e.g. credit spreads, PDs, LGDs and other factors.

**Disclosures**

Under IFRS 7 Financial Instruments: Disclosures a company is required to disclose qualitative and quantitative financial information that enables users of its financial statements to evaluate:

- the nature and extent of risks arising from financial instruments to which the company is exposed at the reporting date; and
- how the company has managed them.

The extent of disclosure will depend on the company’s exposure to risks arising from financial instruments.

Disclosures about climate change have become a much more pressing issue for investors and other financial statements users over the past few years. Because lenders’ credit risk policies need to consider the impact of climate-related risks on their portfolios and how these risks are being managed, it would probably be relevant for lenders to highlight their credit risk policies and concentrations of credit risk to sectors that are more exposed to climate-related risks.

Depending on the significance of the impact of climate-related risks on ECL, it may be important for lenders to disclose:

- the significant judgements made by management in assessing the impact of climate-related risks on ECL;

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\(^1\) For example, transition to a low-carbon economy over time may result in fossil fuel refining assets becoming obsolete.
What’s the impact on expected credit losses?

- the main areas of ECL impacted by the climate-related risks (considering consistency as appropriate with climate-related disclosures elsewhere in the annual report), including:
  - the basis of inputs and assumptions;
  - how forward-looking information has been incorporated into the measurement of ECLs, including the impact on macroeconomic information;
  - changes in estimation techniques or significant assumptions made during the reporting period and the reasons for those changes; and
  - the key climate-related areas of estimation uncertainty impacting ECL.

**Actions for management to take now**

Consider whether:

- the measurement of ECL appropriately captures the types of customers, industries or geographies that are particularly impacted by the economic effects of climate change, which need monitoring for any further acceleration of changes associated with climate-related risk;
- the economic scenarios and/or macroeconomic factors need to be adjusted for climate-related risks;
- the model results need to be adjusted, based on expert credit judgement;
- risks have been double counted by considering the extent to which the risks might already be captured directly or indirectly through ECL model inputs such as credit spreads, PDs, LGDs and other factors;
- credit risk policies and concentrations of credit risk need to be highlighted to sectors that are more exposed to climate-related risks; and
- clear and meaningful disclosures have been provided about significant judgements, assumptions and estimates made.

References to ‘Insights’ mean our publication **Insights into IFRS**