

## **Capturing emerging and novel risks in credit loss provisioning**

In a rapidly changing world, financial institutions face growing challenges in assessing and provisioning for credit losses. The increasingly volatile macroeconomic environment underscores the limitations of relying solely on model-driven estimates as they may be insufficient to accurately reflect emerging and novel risks in credit provisions. Under these conditions, a robust assessment of the allowance requires the use of model risk mitigation techniques to arrive at an adequate estimate that is consistent with the objectives of the accounting framework.

The adoption of International Financial Reporting Standard 9 (IFRS 9) introduced a forward-looking approach to credit loss provisioning, requiring institutions to consider not only historical performance but also current and forecasted conditions that may impact credit losses. Institutions are encouraged to support IFRS 9 allowance estimates with data-driven and model-based approaches that are designed to estimate losses under multiple forecasted economic scenarios.

IFRS 9 models are typically developed using historical data and often perform well when forecasting credit losses in environments similar to the development period. However, during the COVID-19 pandemic, many institutions observed limitations in these models, particularly in periods of heightened economic volatility and when addressing novel or emerging risks.

Since historical data is the primary input for credit risk models, its quality, quantity, and relevance directly influences the model's ability to identify relationships between variables, make accurate predictions, and apply to new situations. When macroeconomic or business conditions deviate from historical experience, model development data may no longer represent future performance. As a result, financial institutions must adopt model risk mitigation techniques, to ensure that their provisioning frameworks remain robust and responsive to emerging risks.

Various industry practices have emerged to address risk factors not fully captured during model development. This paper outlines leading practices for applying model risk mitigants—such as in-model adjustments and post-model adjustments—to enhance IFRS 9 models or outputs in response to novel and emerging risks. Our presentation will illustrate several of these methods to evaluate their effectiveness in predicting credit losses under a range of conditions. In addition, we examine governance considerations relevant to the implementation of these techniques. Finally, we summarize key takeaways to help financial institutions strengthen their approach to managing IFRS 9 model risk and provisioning during periods of uncertainty.