

## Not if but when: Effective Interest Rates, The bridge between credit modelling and accounting within the IFRS 9 framework

### Abstract

IFRS 9 represents a pivotal accounting framework that integrates principles from economics, statistics, and finance to provide a robust and unbiased estimation of expected credit losses (ECL). As an accounting standard, IFRS 9 sets forth a systematic approach to identifying and measuring credit risks, ensuring that financial statements transparently reflect the underlying economic reality. At its core, the framework necessitates a forward-looking assessment of credit risk by employing statistical models and economic forecasts to quantify potential losses, thereby fostering consistent and rigorous financial reporting.

A critical yet often understated component of IFRS 9 is its fair value like treatment of credit losses, specifically through the application of Effective Interest Rates (EIR) to discounting future cash flows to their present value, providing a meaningful basis for comparing not only the amount but also the timing of expected losses across diverse credit portfolios. Despite its significance, the precise definition and application of EIR remain subtly ambiguous, open to interpretation and therefore is subject to considerable diversity in practice within the industry. This has placed EIR estimation as a top priority within the IASB's Amortised Cost Measurement Project for 2025.

In this study we provide some context on how the choice of EIR has shaped the standard (being the reason for day 1 effects as well SICR), and putting it in a general fair value context. Opening up the hood, we look at a number of specific examples where EIR calculations can become quite tricky, such as:

- EIR of a credit card, where most customers are transactors hence pay a contractual rate of 0 %, yet revolving customers pays considerably higher rates.
- EIR for broker acquired lending where a fee is paid to the broker and are capitalized, yet customer can early repay at par meaning that EIR will depend on pre-payment assumptions.
- EIR for intra-group lending as well lending to staff where contractual rates are typically below market, hence implies that the loan must be split into a market loan and capital contribution.
- EIR for sustainability linked loans requires to forecast the sustainable choices the lender makes and probability weight them, opening up for a bank to make "sustainability losses" if the lender reaches the targets faster.

Finally, we look at the ECL impact the choices of EIR has, and how to work to reduce the diversity in practice in parallel of IASB's planned analysis and deliberation of EIR modifications in 2025.

### Authors & Affiliations

Mr Jeames Horn<sup>1</sup>, Mr Jakob Lavrod<sup>2</sup>

<sup>1</sup>Handelsbanken PLC, London, United Kingdom. <sup>2</sup>Svenska Handelsbanken, Stockholm, Sweden