Finance for Europe

Association for Financial Markets in Europe

AFME Position Paper

CRD 5/CRR2: Interaction of IFRS 9 with Capital Requirements

February 2017

Introduction

The move from IAS 39 to IFRS 9 will impact on capital resources. The impact will differ depending on a bank's business model and whether it uses the Internal ratings-based (IRB) approach, the Standardised Approach (SA) or a combination of the two approaches. The relative impact of these differences is as yet uncertain, but it is clear that the move away from an incurred loss model to an expected loss model for credit risk adjustments will lead to an increase in accounting provisions. This will potentially result in material reductions in capital resources under the current prudential regime and subsequently a need for banks to raise additional capital to support ongoing business, without a change in the bank's risk profile. The existing regulatory treatment of accounting provisions, therefore, requires updating to reflect incoming accounting standards and it is clear significant work remains at the Basel Committee to develop an appropriate solution[1]. Whilst the long term solution for the regulatory treatment of accounting provisions remains under development, it is necessary to deploy an interim solution which maintains capital ratios materially at existing levels.

European Interim Solution

We recognise that the European Commission has drafted CRR Article 473a to introduce transitional provisions in order to avoid a potential 'cliff effect' on banks' capital ratios and that the Commission has set a time horizon of five years for the transition. The proposed solution, which phases in Stage 1 and Stage 2 provisions arising from IFRS 9 on a straight-line basis requires reconsideration.

Whilst AFME supports a transitional arrangement, a significant concern is the lack of articulated long-term solution and uncertainty related to the impact of changes to the prudential framework throughout the transition. We believe therefore, that a phasing in arrangement is inappropriate as it implies reaching a defined end state, whilst in this instance there will most likely be a need to move to a different standard at the end of the transitional period to reflect changes made in the prudential framework throughout the transition. For instance, implementing recommendations from the Fundamental Review of the Trading Book (FRTB), such as fair valuing all trading book assets at fair value through profit and loss account[2], will impact on capital resources but will not be reflected in a glide-path as the requirement comes into force post IFRS 9 adoption.

Market expectations also require due consideration, as expectations would be formed on either a misplaced assumption that 'fully phased' numbers represent the end state regulatory requirement or on analysts' own assumptions of the end state requirement, both of which may lead to unintended consequences. A public statement would therefore be necessary from the Commission to make clear that the regulatory treatment is still in development and 'fully phased' numbers should not be viewed as the end state requirement, undermining the credibility of the transitional arrangements.

[1] http://www.bis.org/bcbs/publ/d385.htm

[2] Paragraph 11 of standard: http://www.bis.org/bcbs/publ/d352.pdf

The transitional arrangement we support therefore would be one which maintains, ceteris paribus, capital ratios materially in line with existing levels whilst a long-term solution is finalised. In order to do so, we have developed potential solutions below which retain expected credit losses as captured currently within the prudential regime, adjusting the additional accounting provisions flowing through capital resources.

To be clear, none of the solution options noted below necessarily reflect AFME's / members' view(s) of what the end state of the regulatory framework should look like under IFRS 9:

Option 1

- Add back excess provisions to CET1 capital. Excess provisions in this instance is defined as the difference between Stage 1 + Stage 2 provisions (life time expected loss provisions) and the corresponding one year expected loss across both stages. For IRB portfolios the one year expected loss would be the current regulatory measure of expected loss[3], whilst for Standardised portfolios it would be based on the accounting measure i.e. IFRS 9 Stage 1 one year expected loss provision plus the 12 months bucket of Stage 2 life time expected loss provision.[4]
- For Standardised portfolios, the aforementioned one year expected loss should be subtracted from the exposure in a manner consistent with the current approach to Specific Credit Risk Adjustments (SCRAs). In doing so, the internal consistency of the prudential framework is preserved.
- This method will keep IFRS banks' capital ratios materially unchanged whilst the prudential regime continues to be refined.

Option 2

- Retain Stage 1 and Stage 3 expected losses, reversing the Stage 2 expected loss calculation only. This would be implemented by adding back Stage 2 life time expected loss provision, without restriction, to CET1 capital.
- This option is a simpler approach to Option 1 (whilst not fully aligned with the current prudential framework) and though it does not neutralise the impact of moving from IAS 39 to IFRS 9 and will have some impact on capital ratios, reversing Stage 2 losses represents a significant proportion of the uplift from IAS 39. At the same time, a portion of one year expected losses will be recognised and incurred losses will be tracked.

In addition, we support the 5 year transitional timeline set out in the proposals. This is necessary to allow the banks, the auditors and the regulators to become familiar with ECL provisioning mechanisms. It is at the time of writing quite uncertain how the models will react, taking into account current practices, needs for consistency, and market adaptations to the information provided by the new ECL accounting. All the tentative ideas that banks are working with now are only conceptual and are not necessarily grounded in how users' reactions to the new ECL provisioning will develop. It should also be noted that equivalent US GAAP expected loss accounting will not come into force until two years post IFRS 9 i.e. 2020. As such, an extended period will also help reduce the consequential un-level playing field which would arise from European banks transitioning in the full effects of expected loss provisioning significantly in advance of the US.

[3] Note, a one year time horizon reflects the time horizon for measuring expected loss in the current prudential framework.
[4] We note that, by construct, the Stage 1 excess provision is only equal to the difference between the one year accounting expected loss and the one year regulatory expected loss for IRB portfolios (difference between a Point-in-Time and a Through-the-Cycle measure).

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Consistent Application

We would like to acknowledge that the following AFME recommendations were appropriately reflected in the draft CRR amendments, ensuring that transitional arrangements are applied consistently for all concerned, both in terms of treatment of exposures and implementation timeframe:

- Any specific transitional arrangements for IFRS 9 implementation should be generally available based on the risk weighting approach for the exposures in question, rather than applying selectively for only certain types of bank - AFME considered the option of having different transitional regimes for different types of banks based on whether they used the SA or IRB. This was deemed overly simplistic, with the majority of large banks using a mixture of both approaches to risk weighting of credit exposures at which level IRB permissions are generally scoped.
- In implementing any transitional regime, there should be no national discretions giving competent authorities the ability to front run / fully load measures on an accelerated timeframe i.e. the standard should be applied equally in all jurisdictions - Any acceleration would run counter to the intention of mitigating any sudden unwarranted impact of IFRS 9 expected loss provisioning as well as have implications for cross-border competition.

Strategic Solution

Whilst AFME has not developed a strategic solution, it has identified some potential areas for consideration going forward:

- Threat to IFRS 9 effectiveness: Basel Committee's potential restricting of portfolios eligible for internal risk based modelling whilst asking for more sophisticated IFRS 9 modelling are conflicting measures and will potentially create a disconnect between commercial incentives of loan origination, requirements for provisions under IFRS and regulatory capital requirements.
- Mechanics of the prudential regime will need to be reconsidered to address issues of pro-cyclicality and to capture expected losses appropriately:
    - Greater dynamism will be required in the capital framework to offset the pro-cyclicality arising from IFRS 9 expected losses being a point in time estimate, versus using a through the cycle or downturn measure;
    - Double counting of expected losses within capital resources, through provisions, and within capital requirements (through IRB PDs and SA RWAs) will need addressing. The expected loss component will need to be stripped out from capital requirements calculation or deductions from CET 1 restricted to the unexpected loss component.

In addition, any amendments to address the IFRS 9 accounting issues may risk divergences between IFRS and non-IFRS banks operating in Europe. Due consideration should be given to harmonising the impact of any amendments of the prudential framework to decrease operational complexity and risk in implementation, to create consistency for ease of comparability and to avoid unintended consequences on cross-regional competition. In doing so, policy makers will need to remain mindful of different global standards, e.g. FASB's standards on 'Measurement of Credit Losses on Financial Instruments'.

Please see pages 5-11 of joint IIF-GFMA response letter to the BCBS Discussion Paper, 'Regulatory treatment of accounting provisions', and the Consultative Document, 'Regulatory treatment of accounting provisions – interim approach and transitional arrangements' for a more detailed discussion of the main conceptual issues for prudential regulation stemming from new accounting standards.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.