AFME Position Paper

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

April 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 support the intent of the European Commission in drafting a transitional provision (CRR Article 473a) 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.

Lack of articulated long-term solution

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. It is imperative that an end state solution is developed that recognises the overlaps between the regulatory framework and the new impairment standards. There also needs to be the capability within the CRR to adjust the transitional framework once the appropriate end state has been established.

Dynamic Solution

The transitional arrangement we support 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 which retain expected credit losses as captured currently within the prudential regime, adjusting the additional accounting provisions flowing through capital resources. The solutions we propose are dynamic rather than static because a dynamic approach can better adapt to the changing macro-economic outlook and the profile of a bank's credit book ('Expected Loss factors', EL Factors). Additionally, we believe a dynamic approach is most effective in mitigating the impacts of a market shock during a transition and in helping to achieve the EC's objective of avoiding a 'cliff effect' on capital ratios. A static approach,

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

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conversely, does not adapt to changing EL factors and therefore its ability to offset the 'cliff effect' on capital ratios in a market shock is limited.

We would also like to make clear that a dynamic approach does not necessitate a solution which is overly complex. It should also be recognised that IFRS 9 by nature is dynamic; As such, to introduce a transitional arrangement that is also dynamic would be consistent and allow banks to leverage systems and tools that have been developed for the purpose of implementing IFRS 9 without significant additional investment. This should therefore not be a consideration in deciding between a static and dynamic approach, rather, the best solution to address the potential for a 'cliff effect' on capital ratios should be the deciding factor.

Additionally, it should be noted that a dynamic approach does not add complexity in assessing the impacts of IFRS 9 on CET 1 for stakeholders as any approach would be accompanied by appropriate Pillar 3 disclosures which would set out whether a bank is using the transitional provisions and the related 'fully loaded' CET 1 ratio.

We have set out our proposed solutions below. To be clear, none of the solution options 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.

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[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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- It should be noted that by nature of this being a simpler solution, it is less well calibrated and will see greater volatility in CET 1 ratios versus option 1. This option would still ensure significantly less volatility in CET 1 ratios than an equivalent static approach.

We would like to reiterate that we do not view these solutions as overly complex, and would like to highlight that as per the options presented, there is the option to have simplified forms of a dynamic approach if the complexity remains a concern for policy makers. We believe that a simplified dynamic approach still retains merits over and above those of a static approach.

Transitional timeline

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.

Alternate solutions and level playing field considerations

As articulated, we are in support of neutralisation (or near neutralisation). We believe alternate solutions which consider phasing in the impacts of IFRS 9 are not the most suitable, particularly until the long-term solution is finalised as it implies reaching a defined end state; 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[5], will impact on capital resources but will not be reflected in a glide-path as the requirement comes into force post IFRS 9 adoption. In addition, the impact of changes being considered by the Basel Committee to both the Standardised and IRB Approaches to credit risk, as well as the introduction of a capital floor based Standardised measure may also need to be considered in defining a long-term solution.

It should also be noted that new US GAAP expected loss accounting will not come into force until two years post IFRS 9 i.e. 2020. As such, in the absence of an articulated long term solution for the regulatory treatment of accounting provisions, neutralisation (or near neutralisation) in the first two years of a five year transitional period should be considered at the very least to maintain an international level playing field. This would 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.

Consequential Adjustments

We note that the Basel Standard on the interim approach and transitional arrangements[6] set out the need for consequential adjustments elsewhere in the prudential framework which are directly affected by accounting provisions. We understand that these may be viewed as complex by some and a barrier for considering a dynamic approach. We do not view this as a barrier, but in order to cater for such views, we suggest that institutions are provided with the option of applying a simpler, but more conservative approach.

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

[6] https://www.bis.org/bcbs/publ/d401.pdf

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'.

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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.