afme/ Finance for Europe

CRD 5: Interaction of IFRS 9 with Capital Requirements

February 2017

1 - Overview of Key Messages

1. Significance and potential impacts

The move from IAS 39 (incurred loss model) to IFRS 9 (expected loss model) will impact banks' capital resources without any change in their risk profile

The introduction of IFRS 9 is an important development; at the same time the capital impact of the move will be very significant for banks. As highlighted in the EC impact assessment, a significant number of banks would suffer 'cliff effects' in terms of reduced regulatory capital, which is likely to reduce their lending capacity and ability to support their clients.

2. Industry Recommendations

Until the Basel work on the final regulatory treatment of provisions has been completed, capital levels should remain at current levels

Phasing-in the incremental impacts of IFRS9 when the final Basel rules are in development and the end state as yet undefined, would create market uncertainty, and should not be supported.

Once the regulatory treatment of provisions will be finalized in Basel an appropriate phase-in will be needed

In this respect, the industry supports a dynamic approach, which better reflects the changing profile of a bank's credit book and is more effective at avoiding cliff effects.

Solutions aimed at fast-tracking the IFRS9 provisions are necessary to avoid cliff effects on 1 January 2018

3. Assessment of EC proposals

The EC proposal fully acknowledges the risk of a cliff effect on banks' capital

The EC proposed phase-in requires reconsideration

While we support the objective of the transitional provisions in order to avoid cliff effects on banks' capital, we believe that the proposed phasing in is inappropriate given the lack of defined end-state regulatory treatment. The risk is of transitioning to a state which is different from the end-state. This would create significant market uncertainty.

2 – Detailed AFME Comments

Introduction

IFRS 9 introduces a more forward-looking model for the provisioning of losses

During the financial crisis, the delayed recognition of credit losses that are associated with loans and other financial instruments was identified as a weakness in existing accounting standards. This is primarily due to the fact that the current impairment requirements under IAS 39 are based on an 'incurred loss model', i.e., credit losses are not recognised until a credit loss event occurs.
IFRS 9 will replace IAS39, bringing improvements in that respect by introducing a forward-looking model (expected credit loss model) for the provisioning of loan losses that should lead banks to book earlier provisions than in the past.
IFRS 9 will be applied from 1 January 2018.

The transition from IAS39 to IFRS could lead to cliff effects on banks' capital, unrelated to the banks' risks

Potential 'cliff effects' - The effect of the new requirements will be to require larger loss allowances for banks and similar financial institutions and for investors in debt securities. On transition, this will reduce equity and have an impact on regulatory capital, as also highlighted by the EBA and in the EC impact assessment accompanying the proposal. Such impact will vary depending on various factors (business model; use of internal models or standardized approaches). The EC estimates that for some banks the capital ratios might be reduced significantly, by 0.5 – 1.5 percentage points, impacting negatively on their ability to lend.

The transition to IFRS 9 requires several actions

The introduction of IFRS9 will require solving several issues:

1. ***Defining the regulatory treatment of accounting provisions*** - Prudential rules have traditionally recognised the link between regulatory capital and provisions, in particular the fact that some provisions (e.g. 'general' provisions) have some of the loss-absorbing characteristics of capital and under certain conditions and within certain limits can be included in total capital. With the move to IFRS9 and to a new method for accounting provisions, the regulatory treatment will also need to be revised. In this respect, the Basel Committee is working to develop a solution.

2. ***Designing an appropriate transition to the new regulatory treatment*** – This requires solving two sub-questions:
   a) *How would banks phase-in the new regulatory treatment?* A phase-in will be necessary to avoid the cliff effects mentioned above. At the same time, such phase-in needs to be designed carefully in order to achieve the objective of avoiding cliff effects and to better reflect the changing macro-economic outlook and the profile of a bank's credit book. In the next pages the possible approaches to phase-in (e.g. static approach, dynamic approach) will be explained.
   b) *What should be done while work is under way in Basel to define such treatment?* In this respect, the key objective is to avoid market uncertainty. The only way to achieve this is avoid any incremental capital impact on banks until there is clarity on the final treatment which will be adopted in Basel (see further below for more details).

3. ***The implementation deadline of 1 January 2018*** – In the EU, banks are facing an additional challenge: whatever the solution to the problem described in point 2 above will be, its implementation would be achieved through the CRD5/CRR2 package. However, considering that the final adoption of the CRD5/CRR2 package is not expected before end 2018, while the IFRS 9 will be applied from 1 January 2018, there is a risk that the very problematic cliff effect highlighted above cannot be avoided.

AFME views and recommendations

Below we present AFME's views and recommendations on the above issues:

I. **Until the Basel work on the final regulatory treatment of provisions has been completed, capital levels should remain at current levels**;

II. **Once the regulatory treatment of provisions will be finalized in Basel an appropriate phase-in will be needed;**

III. **Solutions aimed at fast-tracking the IFRS9 provisions are necessary to avoid cliff effects on 1 January 2018**;

I. Until the Basel work on the final regulatory treatment of provisions has been completed, capital levels should remain at current levels

Basel work on the final regulatory treatment of provisions needs to be prioritised

As mentioned above, the final regulatory treatment of IFRS 9 provisions is as yet not defined, as work is under way at Basel level. We believe such Basel work needs to be prioritised and accelerated in order to provide market participants and policy-makers with the necessary clarity.

Until then, capital ratios should be maintained, *ceteris paribus*, in line with current levels[1]. Phasing-in the IFRS9 when the final Basel rules are not final, would create market uncertainty, and should not be supported.

In this respect, we believe that the phase-in proposed by the EC is inappropriate as it implies reaching a defined end state; however, the end state is currently not defined (Basel is still working on it) and it is likely that once defined, banks will need to undergo another transition to reach this newly defined end-state. This would create distorted market expectations and uncertainty.

II. Once the regulatory treatment of provisions will be finalized in Basel an appropriate phase-in will be needed

A phase-in is necessary to avoid cliff effects: the industry supports a 'dynamic approach'

Once Basel has finalised the regulatory treatment of IFRS 9 provisions, a phase-in will be necessary to implement IFRS9. We understand EU legislators are considering various possible approaches: a Static solution or a Dynamic solution (see box below for an outline of the main differences) to the implementation of IFRS 9. In this respect, the industry supports a dynamic approach, which whilst marginally more complex than a static approach, better reflects the changing profile of a bank's credit book and is more effective at avoiding cliff effects.

As to the duration of the transition period, the five years proposed by the EC appear appropriate.

III. Solutions aimed at fast-tracking the IFRS9 provisions are necessary to avoid cliff effects on 1 January 2018

IFRS 9 provisions need to be fast-tracked

We understand EU legislator are considering possible options aimed at fast-tracking the IFRS 9 provisions. Considering the negotiations on the CRD5/CRR2 package are unlikely to be completed before end 2018, a fast-track solution for IFRS 9 is necessary to avoid a very significant reduction in capital resources and hence capital ratios.

[1] To achieve this, we have developed potential options, which are explained in more detailed AFME technical papers. In summary:
Option 1: Add back excess provisions to CET1 capital. This method - which can be adapted to IRB portfolios of standardised portfolios - 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 option is a simpler approach to Option 1 and though it does not neutralise fully the impact of moving from IAS 39 to IFRS 9, it would remove a significant proportion of the capital uplift from IAS 39.

Static vs Dynamic Approach – Outline of main differences

A **simple static approach** which calculates an absolute difference between IAS 39 and IFRS 9 and phases in over 5 years, is simple and does not entail operational burden. However, it exclusively relies on the first-day impact to determine the amount of adjustment and therefore bears little relation to the changing factors over the transition period.

A **semi-static approach** which calculates an absolute difference between IAS 39 and IFRS 9 and then converts it into a percentage of provisions, that is then phased in over 5 years is a more dynamic approach than a simple static approach. It means that as provisions change in size, the size of the transitional relief changes accordingly. Its increased complexity over a simple static approach is not considered a barrier to implementation by the industry, but it is not viewed as the ideal solution given it suffers from similar shortcomings as the simple static approach.

A **dynamic approach**, such as the one put forward by the European Commission in the draft CRR amendments, which offsets Stage 1 and Stage 2 expected credit loss provisions, adapts with changing macro-economic outlook and the profile of a bank's credit book. Our members believe that this approach is not overly complex and is implementable. This approach will also be most effective in mitigating the impacts of a market shock during the transition and in helping to achieve the EC's objective of avoiding a 'cliff effect' on capital ratios.

AFME contacts

Brussels:
Stefano Mazzocchi, stefano.mazzocchi@afme.eu
+32 (0)2 788 3972

London:
Sahir Akbar, sahir.akbar@afme.eu
+44 (0)20 3828 2732

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