# AFME Position Paper

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

September 2016

### 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 extent to which IFRS 9 impacts are overlaid on top of stress testing requirements, given time horizons for stress periods extend beyond IFRS 9 implementation, will also potentially have a material capital impact from next year on banks' capital buffers.

We recognise it is not the European Commission's intent to increase the level of capital required as a result of refinements to the Basel III framework[1], but are also cognisant of the fact that the Basel Committee may not finalise a revised specification of how IFRS 9 accounting interacts with the calculation of bank capital requirements until after IFRS 9 becomes effective 1 January 2018.

### European Interim Solution

In the absence of an articulated end state and whilst Basel III refinements are finalised, AFME believes an interim solution should be introduced in the CRR to help maintain capital ratios at existing levels. The issue arises with the implementation of IFRS 9 because expected losses will now be captured twice; once through accounting provisions, in Stages 1 and 2 of IFRS 9, as well as in the existing prudential regime. As such, this overlap needs addressing and potential solutions have been noted below. To be clear, none of these options necessarily reflects 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[2], 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.[3]
- 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.

[1] Extract from point 4 in letter: http://g8fip1kplyr33r3krz5b97d1.wpengine.netdna-cdn.com/wp-content/uploads/2016/08/Letters-to-Heads-on-G20.pdf

[2] Note, a one year time horizon reflects the time horizon for measuring expected loss in the current prudential framework.

[3] 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).

- 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.

The options suggested are only intended as interim solutions and are designed to materially defer the impact of the uplift in provisions arising from IFRS 9 for a transitional period e.g. 5 years, whilst the Basel prudential framework is updated.

It is recognised that authorities may want to adopt a phased in approach, rather than a deferral of the entire impact over the transitional period. We believe a phasing in / glide-path would not be appropriate given the end state prudential framework is as yet unknown. Notwithstanding this, if a phased approach were to be adopted, reaching 100% should not be viewed as the end state; 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[4], 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, due consideration should be given to any disclosure requirements that will be necessary during a transitional period. In particular, disclosure of information that allows users to infer the portion of IFRS 9 provisions that have been deferred in a transitional period should be avoided as it could undermine the desired effects of any transitional / pro-rated phasing-in arrangements.

**Consistent Application**

Any transitional arrangement should be applied consistently for all concerned, both in terms of treatment of exposures and implementation timeframe:

- 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. 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.
- 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

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

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'.

This is a non-exhaustive list of possible considerations when reviewing a strategic solution to address the misalignment of the accounting and prudential framework. A more complete analysis will be performed in the coming months.

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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.