

3. The likely pro-cyclicality of the IFRS 9 accounting rules: Spanish banks as an illustration

A lesson from the global financial crisis was that banks did not have enough provisions to confront a downturn of the unprecedented magnitude observed in the last global financial crisis, only comparable to the depression of the early 1930s. Following a G20 mandate, the new IFRS 9 rules incorporate a forward looking assessment by moving from an incurred credit loss (ICL) approach to an expected credit loss (ECL) approach for the measurement of impairment allowances with the goal of recognising existing credit losses earlier in the credit cycle.

This early loss recognition incorporated in IFRS 9 seeks at enhancing transparency and the effectiveness of market discipline so that market concerns regarding capital adequacy in a crisis are reduced. Financial statements will therefore reflect the weakness or strength of the reporting institution in a more timely and reliable way. Existing empirical work finds evidence pointing to the fact that the delayed recognition of expected losses has adverse effects on financial stability⁴.

However, estimations of expected credit loss should be interpreted with caution and the benefits should be weighed against potential shortcomings. In particular, some issues with respect to modelling (including data availability) and some potential pro-cyclical effects could be highlighted.

The global financial crisis has cast doubt on the reliability of internal models. Under existing incurred loss models, the Basel Committee identified varied practices in accounting and regulatory provisions across jurisdictions and banks⁵, which may contribute to level playing field concerns and highlighted substantial disparities in the calculations of RWA across banks for similar portfolios⁶.

IFRS 9 establishes broad principles on how to model ECLs but it leaves many important details to the judgement of the reporting entities and their interaction with auditors and regulators. For instance, the shift of exposures from stage 1 to stage 2 (or vice versa) is critically dependent on the practical implementation of the concept of “significant deterioration in credit risk”.

The ECL as implemented through IFRS 9 may have pro-cyclical effects. These effects stem from two sources. On the one hand, from the transition from stage 1 to stage 2 of some loans, which require an increase of provisions corresponding to the expected loss over the life of the loan instead of the expected loss over 12 months. On the other hand, the expected losses parameters (i.e. PDs and LGDs) will follow a cyclical given pattern as ECL is based on a

4: See ESRB (2017): *Financial Stability implications of IFRS 9*, July.

5: See BCBS (2016): *Regulatory treatment of accounting provisions. Discussion Paper*.

6: See, for instance, BCBS (2016): *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*. March.

point-in-time approach rather than an (average) through-the-cycle one. Moreover, these two effects can be magnified by the recency bias as the most recent events have a significant impact in forecasters even when they may have a low relevance.

We have estimated the impact of IFRS 9 for the Spanish banking system in the changeover phase and in a subsequent downturn. Although the impact of IFRS 9 seems limited for the system as a whole (a 21% increase in provisions equivalent to 67 bps of erosion of CET1 in the changeover), it is very heterogeneous across individual banks. According to our estimates, a downturn similar to the one simulated by the EBA Stress Test exercise of 2014 would lead, under IFRS 9, to an increase in provisions equivalent to more than 200 bps of CET1 capital in some Spanish banking groups that represent roughly 21% of the system measured in terms of RWAs (the CET1 capital ratio would drop below 9% in entities that represent 6% of the system). Therefore, the early recognition of losses is expected to have a substantial impact on several entities. This effect may be even further exacerbated if a stress test were to be implemented during a downturn. Although the impact is not very large, it is still relevant and should be monitored, particularly by macroprudential authorities.

According to our simulations, the impact of provisions on banks using the standard approach for the calculation of capital requirements is more contained than on banks using IRB models. This is explained by a higher coverage with provisions. However, SA banks will incur in higher operational cost for the changeover to IFRS 9 because they will most probably have to build their models from scratch.

The potential unintended consequences of IFRS 9 and pro-cyclical effects warrant a series of remedial actions. They could include: a close monitoring by macroprudential authorities with the possibility of counterbalancing the effect through the various capital buffers; clear disclosures from the part of the entities to identify the effects on capital stemming from the implementation of the new rules and distinguish them from actual deterioration in capital levels; the implementation of dynamic transitional arrangement as proposed by the Basel Committee as they allow for ECL provisions to fluctuate over time, which is not the case for the static transitional arrangement.

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