

IMPLICATIONS OF THE IFRS 9 IMPAIRMENT MODEL FOR FINANCIAL STABILITY

IFRS 9 (მოსალოდნელი საკრედიტო დანაკარგების) მოდელის გავლენა ფინანსურ სტაბილურობაზე

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Abstract

The objective of this paper is to examine the interaction of the new model of IFRS 9 with supervisory rules. It discusses potential implications for financial stability. We assess whether the IFRS 9 expected credit loss model better reflects credit quality of financial assets and whether it reduces the pro cyclicalities of loan loss allowances as compared to the IAS 39.

By benchmarking the IAS 39 and IFRS 9 models, we find that the expected credit loss model of IFRS 9 includes a significantly larger set of information relevant for identifying future expected credit losses. IFRS 9 requires earlier and larger impairment allowances, which will limit the possibility of distributing, overstated profits in the form of dividends and bonuses. Above these, it will reduce the build-ups of loss overhangs and the overstatement of regulatory capital in boom periods, which in turn, will mitigate capital inadequacy concerns in a downturn. IFRS 9 can mitigate the amplifying effect of the incurred loss approach on pro cyclicalities and enhance financial stability.

Key words: financial stability, credit loss, credit quality, financial assets

ანოტაცია

სტატიის მიზანს წარმოადგენს შეისწავლოს ურთიერთმოქმედების მექანიზმი ერთი მხრივ IFRS 9 ახალ მოდელსა და მეორე მხრივ არსებულ საზედამხებელო წესებს შორის. აგრეთვე განვიხილავთ ამ მოდელის შესაძლებელ გავლენას ფინანსურ სტაბილურობაზე. IFRS 9 მოდელი მოითხოვს წინასწარ საკმაოდ მოცულობის რეზერვების არსებობას, რომელიც თავის მხრივ შეზღუდავს განაწილების შესაძლებლობასა და მოგების გაზრდას დივიდენდებისა და ბონუსების ხარჯზე.

ჩვენ ვაკეთებთ შეფასებას იმისას, თუ რამდენად ასახავს მოსალოდნელი საკრედიტო დანაკარგების IFRS 9 მოდელი ფინანსური აქტივების საკრედიტო თვისებებს და ამცირებს თუ არა სესხების დანაკარგის რეზერვების ბრუნვადას IAS 39 მოდელთან მიმართებაში. თუ შევადარებთ ერთმანეთს ამ ორ მოდელს, ჩვენ აღმოვაჩინებთ, რომ მოსალოდნელი საკრედიტო დანაკარგის IFRS 9 მოდელი მოიცავს ინფორმაციის საკმაოდ დიდ ნაკრებს, რაც მნიშვნელოვანია სამომავლო მოსალოდნელი საკრედიტო დანაკარგების განსასაზღვრავად. ამას გარდა ამ მოდელის გამოყენება იწვევს ნორმატიული კაპიტალის ზრდას აღმავლობის პერიოდში და სამაგიეროდ ასუსტებს კაპიტალის დანაკლისის პრობლემას ეკონომიკური კრიზისის დროს. IFRS 9 მოდელი არბილებს მიღებული დანაკარგების გამაძლიერებელ ეფექტებს და შესაბამისად ზრდის ფინანსური სტაბილურობის ალბათობას.

საკვანძო სიტყვები: ფინანსური სტაბილურობა, საკრედიტო დანაკარგი, საკრედიტო ხარისხი, ფინანსური აქტივები

The IFRS 9 expected loss model is more aligned with the regulatory expected loss model. However, differences pertain to the scope, the applicable parameter estimates and to the relevant time horizon. The scope of IFRS 9 is wider since it applies to all financial assets measured at amortized cost and financial assets measured at fair value through other comprehensive income, while the regulatory expected loss requirements apply only to internal ratings-based (IRB) banks. For regulatory purposes, expected loss should be measured using through-the-cycle estimates of probability of default and downturn loss given default, which generally results in more conservative and smoother expected loss amounts. Since the expected credit loss model of IFRS 9 aims to reflect current economic conditions, point-in-time parameter estimates should be used to measure expected credit losses, which will yield accounting expected credit loss amounts that can vary considerably over the business cycle.[1, 25]

However, the impact of IFRS 9 on regulatory capital will be moderate for IRB banks. During boom times, through-the-cycle regulatory expected loss will generally exceed point-in-time accounting expected credit losses. In a downturn, expected credit losses under IFRS 9 are likely to exceed regulatory expected loss due to the increased recognition of lifetime losses, which impact Tier 1 capital, but 'excess' provisions can be included as part of Tier 2 capital. In contrast, the larger expected credit losses under IFRS 9 - relative to IAS 39 - will have a direct impact on the Tier 1 capital of Standardized Approach banks (compared to IRB banks), while 'collective provisions' might be eligible to be included in Tier 2 capital. [8, 81-100]

The paper also illustrates that IFRS 9 can partly mitigate a design flaw in the European implementation of Basel III in the Capital Requirements Regulation (CRR), where effectively banks do not have to hold regulatory capital to cover the risks inherent in European sovereign exposures. If consistently applied, IFRS 9 will require the recognition of expected credit losses that are commensurate with the riskiness of the underlying sovereign exposures, and thus, result in a regulatory capital charge. Given the significant systemic risks stemming from the tremendous sovereign exposures of European banks, IFRS 9 can contribute to improving financial stability in this area. [4, 15-21]The paper highlights the role supervisors can play in the enforcement of IFRS 9, but also points to potential threats posed by too conservative supervisory interpretation of the accounting rules and by too much supervisory intervention into loan loss provisioning forth consistency and integrity of financial reporting. The divergence in loan loss accounting practices under IAS 39 resulted primarily from the different interpretation of the incurred loss approach by bank supervisors across jurisdiction in the European Union. In this regard, the European Banking Authority's efforts are crucial in harmonizing supervisory practices, and as consequence, in achieving a consistent application of the expected credit loss approach. [9]The extended disclo-

sure requirements related to the IFRS 9 expected credit loss model are likely to contribute to the transparency of the process of loan loss accounting, and thus, to promote market discipline. In addition, supervisory disclosures in banks' individual reports and the periodic aggregate supervisory disclosures from stress tests will support market participants' and supervisors' assessment of the validity and adequacy of reported expected loss amounts. [7, 259-273].

Overall, we believe that the IFRS 9 expected loss approach represents a reasonable compromise between providing relevant information and catering for the needs of supervisors to enhance financial stability. However, the closer alignment of accounting and supervisory rules in combination with the increased minimum capital requirements under the Capital Requirements Regulation will reinforce bank managers' incentives to opportunistically manipulate loan loss amounts to avoid breaches of regulatory thresholds, which trigger limitations of dividend and bonus payments. The IFRS 9 model will provide significantly wider scope for managerial discretion than IAS 39. Therefore, whether the introduction of the expected loss approach will yield the desired benefits will ultimately depend on the proper and consistent application of the rules. This, in turn, will require the joint effort of preparers, auditors, supervisors and enforcement bodies. Since the beginning of the recent financial crisis starting in 2008, the delayed recognition of loan losses under the incurred loss approaches been criticized as a major weakness of financial accounting standards. A fundamental problem with the incurred loss model is that impairment allowances for credit losses tend to be at their lowest level before an economic cycle trends downward and actual losses begin to emerge ('too little too late'). Several high profile groups have argued that the incurred loss approach reinforces the pro-cyclical effects of bank regulation and called standard setters to develop accounting standards that allow for a more forward looking provisioning¹. There is an expectation that earlier recognition of loan losses would mitigate pro cyclical and thereby enhance financial stability. In response to these calls the IASB issued the final version of IFRS on 9 July 2014 which requires the incorporation of information about future expected credit losses in provisioning and an earlier recognition of loan losses than under IAS 39. [3, 293-386.] The purpose of this paper is to examine the interaction of the new expected loss approach of IFRS 9 with supervisory rules and discuss potential implications for financial stability. In doing so, I also assess whether the IFRS 9 expected credit loss model better reflects credit quality of financial assets and whether it reduces the pro cyclical of loan loss allowances as compared to the incurred loss approach of IAS 39.

First, we discuss the main conceptual differences between IAS 39 and IFRS 9 and highlight the main features of the expected loss model that make it more forward-looking. I also assess whether IFRS 9 better reflects the credit quality of financial assets and

whether additional qualitative criteria would improve the expected loss model. Second, we examine how IFRS 9 interacts with the three pillars of bank supervision which are- Minimum regulatory capital requirements (Pillar 1),- Supervisory review (Pillar 2), and- Market discipline (Pillar 3). In doing so, we emphasize that financial reporting and bank supervision pursues different objectives and this is reflected in differences in the measurement and supervisory treatment of impairment losses. In the first Pillar, loan loss provisions are used as input in regulatory capital calculations, and thus have a direct impact on regulatory capital. We discuss the differences in the measurement of regulatory and IFRS 9 expected loss, and how these differences affect the calculation of regulatory capital. Supervisors evaluate banks' internal credit risk management systems and assess the adequacy of loan loss provisions. We discuss the recent guidance issued by the Basel Committee on Banking Supervision which outlines supervisory expectations with regard to expected loss accounting. Because supervisors can, through the supervisory review process, significantly influence how expected loss accounting rules are applied highlighted. [2, 293-386.]

The importance of consistency of supervisory practices that has been a major issue within the European Union (EU). Relatedly, we show how too much supervisory intervention can be detrimental to the integrity of financial reporting. Since loan loss accounting significantly disciplines the third pillar of bank supervision. Therefore, we discuss the role of expected loss related disclosures and their interaction with supervisory disclosures in banks' Pillar 3 reports and in aggregate disclosures in stress test reports. Third, we discuss issues related to the potential impact of IFRS 9 on financial stability. Specifically, I evaluate whether the expected loss model of IFRS 9 has less pro-cyclical tendencies than the incurred loss approach of IAS 39. Then, we discuss concerns regarding the scope for managerial discretion in loan loss accounting under IFRS 9 and its implications for financial stability. Furthermore, we evaluate the complexity of the new expected loss approach particularly stemming from its interaction with supervisory rules. [2, 399-423.]

Finally, we review selected studies that provide interesting insights with respect to the issues mentioned above. Specifically, we discuss empirical evidence on the effects of the mandatory adoption of IAS 39 on bank loan loss provisioning in the EU and the lessons that can be learned from that experience. In addition, we discuss recent studies that exploit cross-bank variation in the application of the incurred loss model or cross-country variation in the extent of discretionary loan loss provisions and examine the channels through which managerial discretion in loan loss provisions can impact financial stability.

Based on the comparison of the IAS 39 and IFRS 9 impairment models, we can conclude that: • the expected loss model of IFRS 9 incorporates a significantly larger set of information relevant for identifying future

ECLs and lead to an earlier recognition of losses. As a result, it better reflects the credit quality of financial assets, and therefore, addresses the G20 (and others') call for strengthening the accounting recognition of loan losses by incorporating a broader range of credit information. In addition, IFRS 9 addresses some supervisory concerns, because it will require larger loan loss allowances, which will reduce the build-ups of loss overhangs and the overstatement of regulatory capital in boom periods. Furthermore, earlier and larger loan loss allowances limit the possibility of distributing overstated profits in the form of dividends and bonuses. Through these channels IFRS 9 can mitigate the amplifying effect of the incurred loss approach on pro-cyclicality and reduce capital inadequacy concerns during crisis. In addition, the earlier reporting of ECLs and extended disclosures requirements will improve transparency and contribute to more effective market discipline. Reduced capital inadequacy concerns combined with improved market discipline are likely to enhance financial stability. However, several issues have been raised in the paper: First, the initial recognition of 12-month ECL is somewhat arbitrary and lacks conceptual justification; The stepwise recognition of loan losses in Stage 1 and Stage 2 will often lead to an over- or understatement of loan loss allowances. The magnitude of these will depend on how banks apply the IFRS 9 requirements, how timely they incorporate relevant information and update loan loss allowances. This is particularly an issue with regard to financial assets moving from Stage 1 and Stage 2 and the corresponding switch from 12-month ECL to the recognition of lifetime ECL.

If management is not able or not willing to identify 'significant increases' in credit risk on a timely basis, the switch from Stage 1 to Stage 2 would result in significant 'cliff effects' creating the same problems as IAS 39. In this regard, the paper notes that the scope for judgment and managerial Discretion is substantially wider than under IAS 39. Finally, similarly as IAS 39, IFRS 9 requires the expected cash flows to be discounted using the original effective interest rate, which results in net loan amounts that merely represent an accounting artifact.

The IFRS 9 expected loss model is more aligned with the regulatory expected loss under the IRB approach. However, differences pertain to the scope, the applicable parameter estimates and to the relevant time horizon. The IFRS 9 expected loss approach applies to all financial assets measured at amortized cost and FV-OCI assets, while the regulatory expected loss only applies to IRB portfolios. Due to the reliance of IFRS 9 on PIT parameter estimates accounting ECLs will be more cyclical than TTC regulatory expected loss. However, the impact of IFRS 9 on regulatory capital will be moderate for IRB banks. During boom times TTC expected loss will generally exceed accounting PIT ECLs. In a downturn, ECLs under IFRS 9 are likely to exceed regulatory expected loss due to the increased recognition of lifetime losses, which impact Tier 1 capital, but 'excess' provisions can be included as part of Tier 2 capital. In

contrast, the larger ECLs under IFRS 9 relative to IAS39 will have a direct impact on Tier 1 capital of Standardized Approach banks, but ‘collective impairment provisions’ might be eligible for inclusion in Tier 2. The paper also illustrates that IFRS 9 can to some extent mitigate a design flaw in the European implementation of Basel III in CRR, where effectively banks do not have to hold regulatory capital to cover the risks inherent in European sovereign exposures. If consistently applied, IFRS 9 will require the recognition of ECLs that is commensurate with the riskiness of the underlying sovereign exposures, and thus, result in a regulatory capital charge. Given the significant systemic risks stemming from the tremendous sovereign exposures of European banks, IFRS 9 can contribute to improving financial stability in this area.

We also highlight the role supervisors can play in the enforcement of IFRS 9, but also point to threats posed by too conservative supervisory interpretation of the accounting rules and by too much supervisory intervention into loan loss provisioning for the consistency and integrity of financial reporting. In this regard, the EBA’s efforts are crucial in harmonizing supervisory practices, and as consequence, in achieving the consistent application of the expected loss approach. Whether

the introduction of the expected loss approach will yield the desired benefits will ultimately depend on whether the rules will be applied properly and consistently. This, in turn, will require the joint effort of preparers, auditors, supervisors and enforcement bodies. Overall, we believe that the IFRS 9 expected loss approach represents a reasonable compromise between providing relevant information and catering the needs of supervisors to enhance financial stability.

By benchmarking the IAS 39 and IFRS 9 models, we find that the expected credit loss model of IFRS 9 includes a significantly larger set of information relevant for identifying future expected credit losses. IFRS 9 requires earlier and larger impairment allowances, which will limit the possibility of distributing, overstated profits in the form of dividends and bonuses. Above these, it will reduce the build-ups of loss overhangs and the overstatement of regulatory capital in boom periods, which in turn, will mitigate capital inadequacy concerns in a downturn. IFRS 9 can mitigate the amplifying effect of the incurred loss approach on pro cyclical and enhance financial stability.

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