IFRS 9
and
Cyclical Risks in the Banking Sector

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IFRS: Global rules & local use – beyond the numbers
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To Provision or Not to Provision

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- Debate on the role of provisioning for impaired assets in banking regulation is not a new one.
- Borio and Lowe (2001) – To Provision or Not to Provision:
  - A paper written prior to implementation of a new set of regulations (Basel II, IAS 39),
  - Focuses on an inherent conflict between the interests of supervisors and accountants,
  - Financial supervisors tend to emphasize the role that provisions can play in ensuring that banks maintain adequate buffers against future deteriorations in credit quality,
  - Accounting authorities have stressed the importance of provisions in generating fair and objective loan valuations.
- The accountants won the battle at that time but after a few years (after GFC) the debate on provisioning started over.

Forward-Looking Provisioning

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- The key argument of regulators for forward-looking provisioning is the inherent tendency of banks to excessively relax lending standards during economic upturns and tighten them too much during downturns, contributing thus to general procyclicality.
  - risks are being underestimated during upturns leading to credit booms with loans extended with prices set too low,
  - subsequent downturn leads to re-pricing under the impact of higher default rate, prices are too high, potentially ending in a credit crunch.
- Forward-looking provisioning should therefore help to ensure correct pricing of expected credit risk (via margins) arising at the time when credit is extended.

Backward-Looking Provisioning

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- The standards agreed in 2003 and in force until 2018 (IAS 39) were of a backward-looking nature.
  - Allowed banks to provision only for loans for which there was clear evidence of impairment (incurred loss approach).
  - Provisions were created and entered in the accounts only after credit risk came to light (not surprisingly in times of recession, i.e. during the GFC).
- Financial Times website: 4 December 2012 - Welcome to Japan-style crisis management by John Plender:
  - The banks sell at a discount of around a third to net asset value because of uncertainty about the value of assets.
  - The biggest source of (potential) overvaluation relates to the form of provisioning required by IFRS which operates on an incurred loss basis.
  - Banks have only a limited ability under this rule to make full provision for expected losses.

Bright Promises

- Facing criticism of IAS 39 and conclusions of a report produced by the Financial Stability Forum's Working Group on Provisioning, the International Accounting Standards Board (IASB) suggested a move to the expected loss (EL) approach in June 2009 as part of the IASB's project on replacing IAS 39.
- After a long debate, IFRS 9 - governing the recognition, derecognition, classification and valuation of financial assets and hedge accounting - came to life in 2018.
- A major deviation from the incurred loss approach was initially awaited and hopes were being expressed that:
  - It should better reflect the economic reality of banks' lending activities than the incurred loss approach in that it requires an earlier recognition of expected credit losses,
  - It should help to avoid "incurred but not reported losses".

IFRS 9 and Credit Risk in Banks

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- Current approach to credit risk is both backward- and forward-looking.
  - IFRS 9 requires correct and timely recognition of both materialized credit risks (a backward-looking view), when loan impairment has already taken place (non-performing loans – NPLs, Stage 3 – impaired),
  - and future expected credit risks (a forward-looking view) for loans that do not currently show any evident signs of impairment (performing loans, Stage 1 – no increase and Stage 2 – increase).
  - Banks cover recognized materialized and future expected credit risks with provisions.

Dismal Performance?

- ESRB report 'Financial stability implications of IFRS 9' published in July 2017 says that IFRS 9 is a step in a good direction, but may also have a significant procyclical effect.
  - The main issue is potential restriction of lending activity by banks connected with the need to create large amounts of provisions after they receive unexpected information indicating a weakening of the aggregate economic conditions.
  - This sharp increase in provisions ("cliff effect") may in turn cause sizeable losses and a fall in capital.
- A major issue is Stage 1 exposures for which only 1Y horizon losses, not life-time losses, are assumed.
  - Banks may create negligible provisions in good times despite taking more risk on board.

IFRS 9 and Financial Stability

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- CNB's Financial stability report published in June 2018 concludes that only a small increase in provisions after IFRS 9 introduction could indicate that at certain stages of the financial and business cycle, IFRS 9 may not lead to significantly higher provisioning compared to IAS 39.
  - Some of the expectations regarding the countercyclical effect of IFRS 9 (timely and sufficient provisioning) may not fully materialize in time.
  - This increases the importance of timely application of the countercyclical buffer or other capital add-ons to make the banking sector resilient to adverse economic developments well before the expected loss models used under IFRS 9 lead to higher provisioning.

IFRS 9 and Vulnerability of Banks to Cycle

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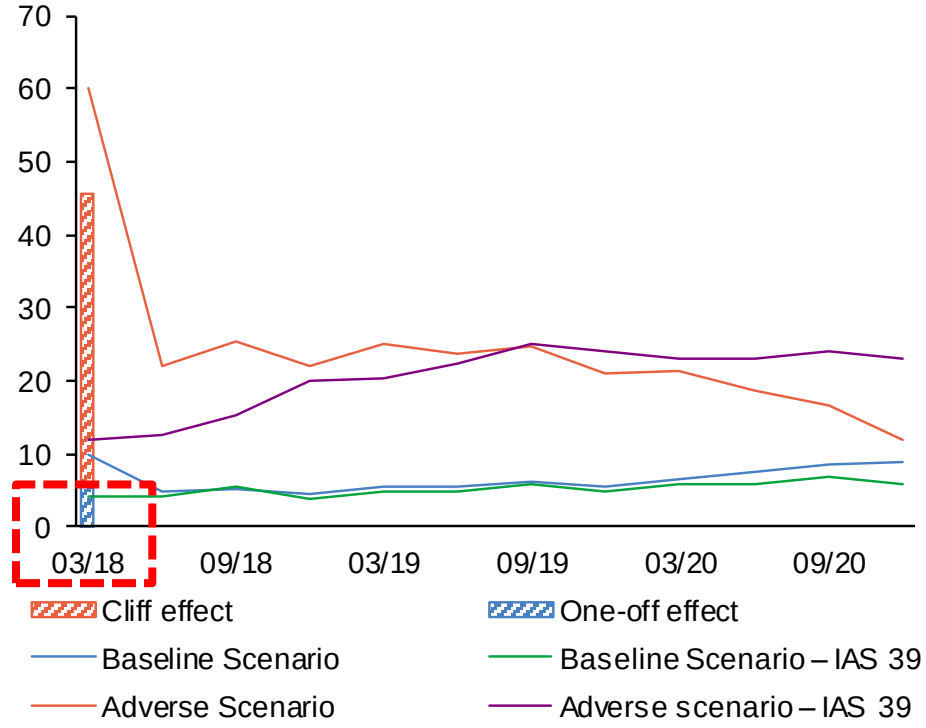
- Scenario:
  - Banks enjoying good times for couple of years, increased profits thanks to lower risk costs, (slow inflow of NPLs and declining provisions for non-NPLs).
  - Declining risk weights in IRB banks leading to improvement of capital ratios despite fast credit growth and creating room for higher dividends.
- Subsequent adverse shock:
  - Provisions going up for both NPLs and non-NPLs.
  - Losses in some banks and increase of risk weights in IRB banks reducing capital cushions.
  - Reduced capacity to lend to real economy.
  - Vicious circle leading from non-available credit to decline in economic activity and rising unemployment.

CNB's Macro-Stress Test, June 2018

- Introduction of IFRS 9 leading to some increase in provisions for non-NPLs (Stages 1 and 2) relative to IAS 39.
- CNB's model in Baseline scenario assumes CZK 5.4 billion extra provisions for existing non-NPLs, a "one-off effect".

Quarterly creation of total provisions
(CZK billions)



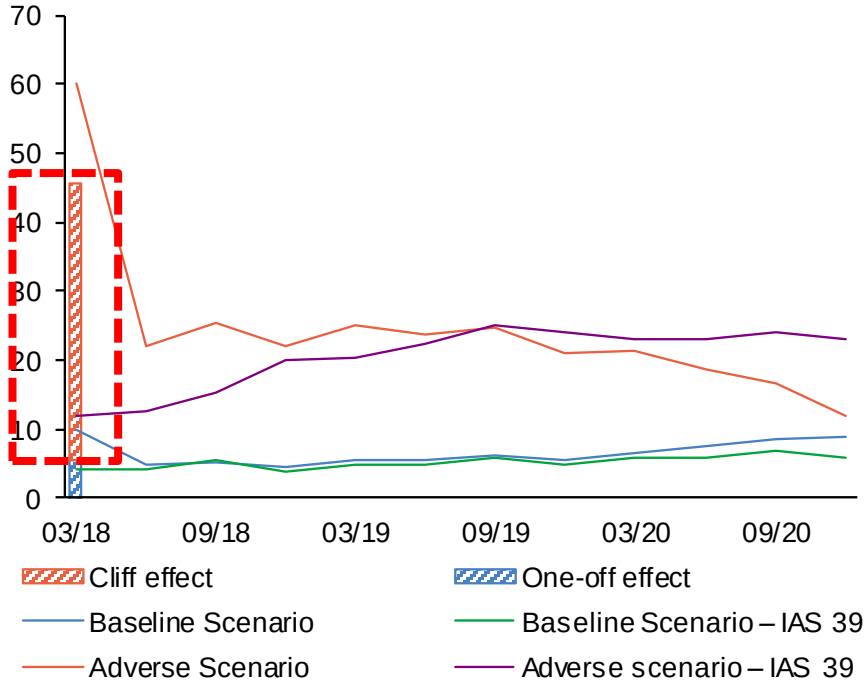
Source: CNB

Note: For IAS 39 the model assumes constant coverage of performing loans by provisions. For IFRS 9 and IAS 39 provisions for non-performing loans equal credit losses. The one-off and cliff effects capture the change between 31 December 2017 and 1 January 2018.

CNB's Macro-Stress Test, June 2018

- The model assumes, in the an *Adverse Scenario,* an additional jump in provisions for non-default loans of CZK 40.3 billion, or a "cliff effect".
- The size of the effect is owing to assumption of perfect foresight on the part of the banks.
- Adaptive behavior would make the increases in provisions less dramatic and more distributed over time.

Quarterly creation of total provisions
(CZK billions)



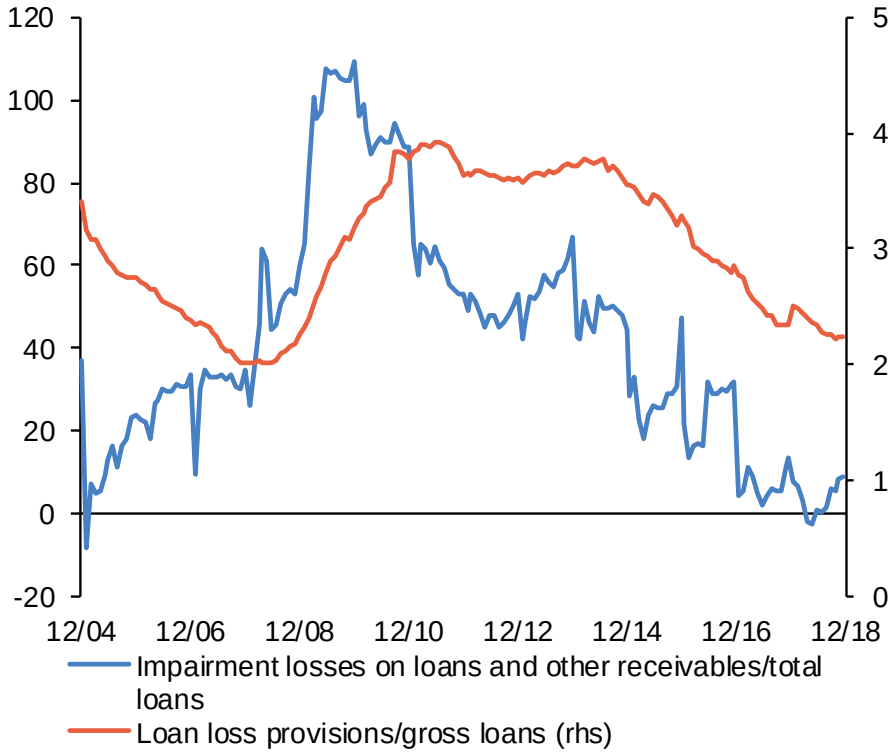
Source: CNB

Note: For IAS 39 the model assumes constant coverage of performing loans by provisions. For IFRS 9 and IAS 39 provisions for non-performing loans equal credit losses. The one-off and cliff effects capture the change between 31 December 2017 and 1 January 2018.

Effects of IFRS 9 Introduction at CZ banks

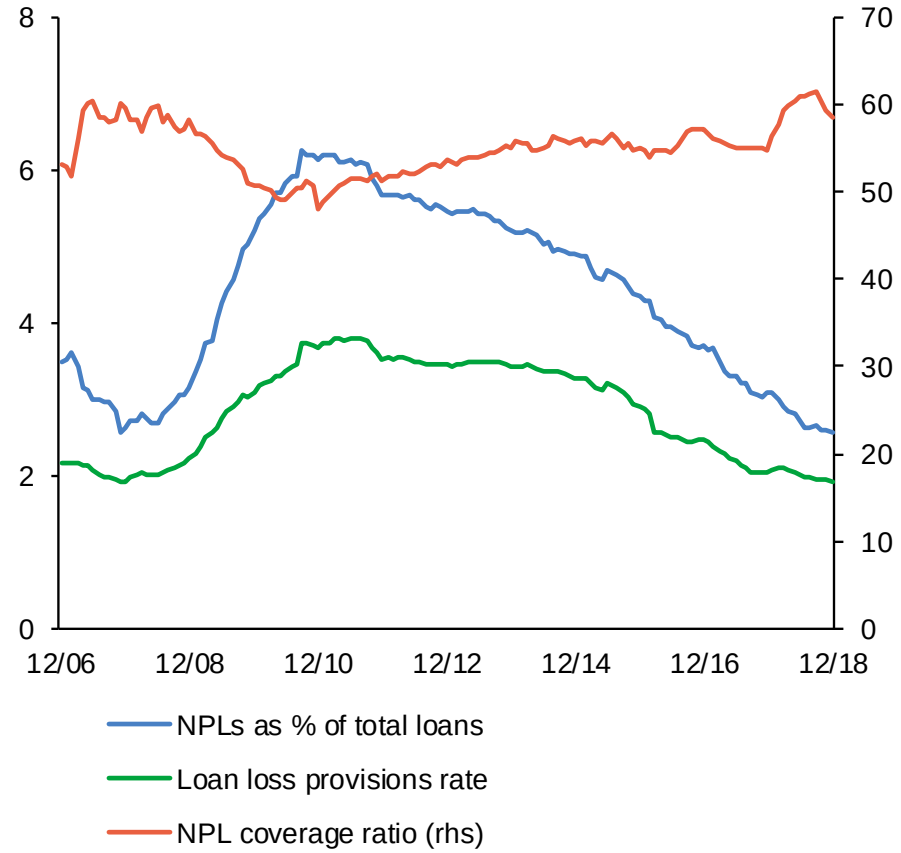
- Introductory effect was marginal and temporary.

Asset impairment losses and loan loss provisions
(bp; right-hand scale: %)



Source: CNB
Note: Impairment losses are the ratio of growth in net impaired loans to total bank loans.

Non-performing loans and provisions in the domestic banking sector
(%)

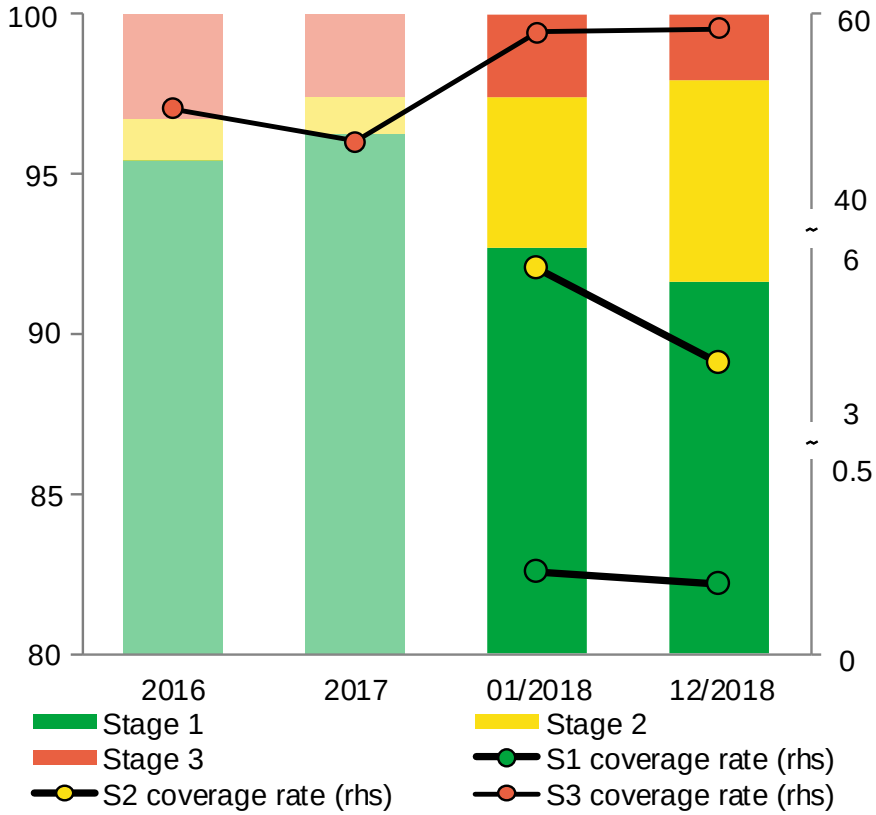


Source: CNB

Effects of IFRS 9 Introduction at CZ Banks

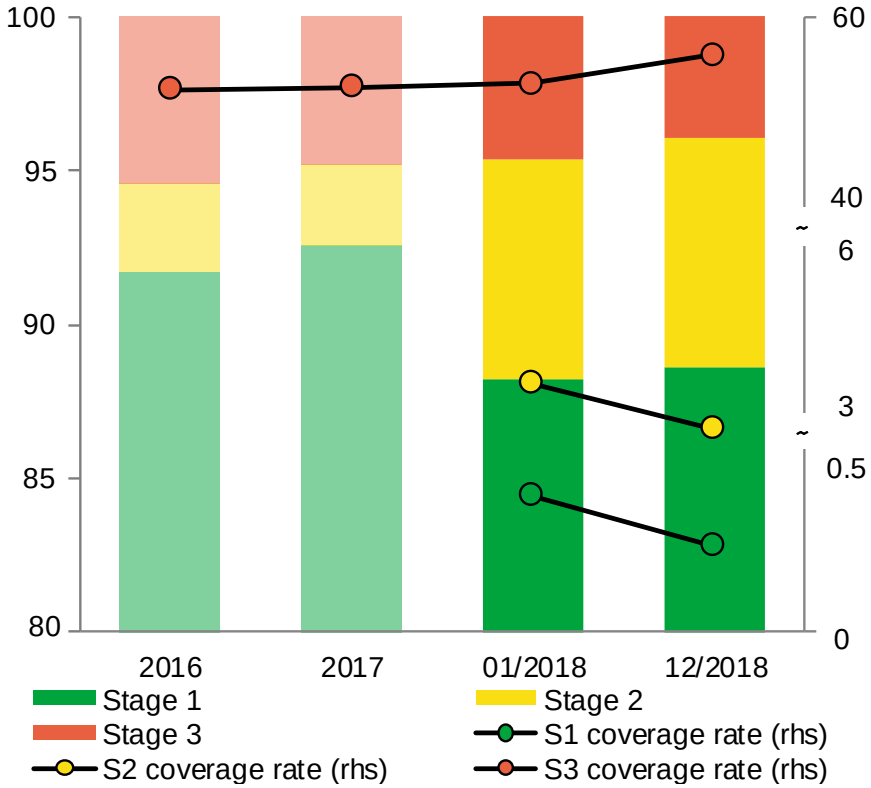
- Expected losses from performing loans (Stages 1 and 2) are currently rather low.

Structure and coverage of loans to households
(%)



Source: CNB

Structure and coverage of loans to NFCs
(%)



Source: CNB

Effects of IFRS 9 Introduction at CZ Banks

- Coverage of performing loans decreased during 2018 relative to IFRS start at the beginning of the year.

Structure of exposures according to level of risk and coverage by provisions after the introduction of IFRS 9
(change between 31 Jan 2018 and 31 Dec 2018 in %)

			Households		Non-financial corporations		Aggregate	
Coverage ratio								
Total			1,6%	-15,3%	2,8%	-8,7%	2,2%	-11,8%
Of which:	No increase in risk (Stage 1)	Performing	0,2%	-2,9%	0,3%	-12,5%	0,2%	-8,1%
	Increase in risk (Stage 2)		4,2%	-22,4%	3,2%	-11,2%	4,2%	-16,0%
	Impairment (Stage 3)	Non-performing	58,8%	0,9%	57,3%	7,0%	57,5%	4,3%
Exposures								
Total			1 734	7,1%	1 330	6,7%	3 063	6,9%
Of which:	No increase in risk (Stage 1)	Performing	1 589	5,9%	1 178	7,2%	2 767	6,5%
	Increase in risk (Stage 2)		109	43,1%	99	10,5%	208	25,5%
	Impairment (Stage 3)	Non-performing	36	-14,9%	52	-8,7%	88	-11,3%
Provisions								
Total			29	-9,3%	37	-2,6%	65	-5,7%
Of which:	No increase in risk (Stage 1)	Performing	3	2,9%	3	-6,2%	6	-2,2%
	Increase in risk (Stage 2)		5	11,0%	3	-1,8%	8	5,4%
	Impairment (Stage 3)	Non-performing	21	-14,1%	30	-2,3%	51	-7,5%

Source: CNB

Note: The figures in the first, third and fifth columns indicate stocks as of 31 December 2018. The “Aggregate” values aggregate the information for both sectors.

Concluding Remarks

- IFRS 9 is a step in a good direction since it treats credit risk in both a backward- and forward-looking manner.
- Potential for a cliff effect creates a case for timely response of both micro- and macro-prudential authorities to cyclical risks.
- Response through use of macroprudential capital buffers in good times is hardly a best solution - using microprudential tools could serve the purpose better.
- From a financial stability perspective some changes to IFRS 9 would be warranted.

THANK YOU FOR YOUR ATTENTION

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