

IFRS 9 from the perspective of banking supervision

Since the beginning of the 2018 financial year, publicly traded credit institutions in the EU have been required to apply the new International Financial Reporting Standard (IFRS) 9 when accounting for financial instruments in their consolidated financial statements. IFRS 9 was developed in response to G20 criticism about accounting standards during the course of the financial crisis, which singled out the late and insufficient recognition of loss allowances (“too little, too late”). In contrast to the incurred loss approach under the previous International Accounting Standard (IAS) 39, IFRS 9 now requires preparers to account for expected credit losses.

Implementation of the new impairment model is changing the way in which credit institutions that prepare their financial statements in conformity with IFRSs draw up their accounts. Furthermore, in some cases, they can now exercise considerable discretion when calculating their expected credit losses. How banks utilise this discretion is also a topic that concerns banking supervisors, who have a vested interest in timely and appropriate provisioning and in balance sheets that enable credit institutions to be assessed on as level a playing field as possible.

At the transition date, German institutions saw a moderate rise in their loss allowances of just under 6% on average as well as a decline in their Common Equity Tier 1 (CET1) capital ratios of 11 basis points. It will only be possible to gauge whether any adjustments to the regulatory treatment of accounting loss allowances will be needed in the long term once robust data are forthcoming. German institutions have so far not made use of the transitional arrangements allowing them to phase in the impact of IFRS 9 on regulatory capital.

There is generally no need to amend the relevant accounting rules set forth in the German Commercial Code (HGB), as this set of rules already implicitly contains the option of taking into account forward-looking components in the form of the principle of prudence as well as the concept of setting aside general loss allowances.

IFRS 9 as a response to the financial crisis

■ Introduction

The international accounting standards for financial instruments attracted mounting criticism as the global financial crisis unfolded. A majority view emerged that if impairments had been accounted for earlier, it might have been possible to dampen cyclical moves in the crisis.¹ The recognition of loss allowances on financial assets in conformity with the existing accounting standards at that time, meanwhile, was described by many as “too little, too late”. Additional criticism was sparked by the variety of permissible measurement methods, which gave the accounting framework a reputation for being too complex and having little basis in principle. This was the background against which the G20 heads of state and government, in analysing and learning from the financial crisis, called for a reform of the accounting standards, amongst other things, in April 2009.²

Following intensive deliberations and consultations, the International Accounting Standards Board (IASB) ultimately responded to the G20’s call to action on 24 July 2014 by publishing IFRS 9 as the new standard for accounting for financial instruments. The most significant innovation is the introduction of the expected credit loss (ECL) model when recognising loss allowances, which aims to promote the earlier recognition of credit risk. Another change introduced a principles-based approach to classifying and measuring financial assets in an effort to reduce the number of measurement methods and make financial reporting more comprehensible. Lastly, in the area of hedge accounting, the IASB made adjustments to align financial reporting more closely with risk management practice.

The new IFRS 9 standard was endorsed by the EU in November 2016 through Commission Regulation (EU) 2016/2067, and its application became mandatory on 1 January 2018 for all publicly traded entities when accounting for financial instruments in their consolidated financial statements. Since both securities and

loans are considered to be financial instruments for the purposes of IFRS 9, it is highly relevant for the accounting of credit institutions.

The annual and consolidated financial statements of credit institutions and external auditors’ reports on these financial statements are some of the most important sources of information for the Bundesbank in performing its mandate to contribute to preserving the stability of the banking system. Supervisors use the information contained in annual and consolidated financial statements, and in the supervisory reporting based on them, to assess the risk situation as part of the ongoing supervision of credit institutions. Furthermore, the carrying amounts reported by institutions form the basis for determining the adequacy of their regulatory capital. It is therefore in the interest of supervisors that credit institutions recognise existing risks in a timely manner and take proper consideration of them in their accounts. For this reason, the Bundesbank, like other central banks and supervisory authorities, closely followed the development and implementation of IFRS 9. The objective was to gain a thorough grasp of the impact of the new standard and to work towards ensuring that its implementation does indeed address the G20’s points of criticism and contribute to the stability of the banking system.

■ Key requirements of IFRS 9

To push the development of the new accounting standard ahead as quickly as possible, the IASB divided work on IFRS 9 into three project phases. Phase 1 revised the rules for recognising and measuring financial instruments, phase 2 introduced an overhauled impairment

Highly relevant to credit institutions and supervisory authorities

¹ See Financial Stability Forum (2009), Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System, p. 4. Available at http://www.fsb.org/wp-content/uploads/r_0904a.pdf

² See G20 (2009), Declaration on Strengthening the Financial System, London summit. Available at <http://www.g20.utoronto.ca/2009/2009ifi.pdf>

model, and phase 3 was dedicated to hedge accounting.

Recognition and measurement of financial instruments

Principles-based approach to classification and measurement

The oft-criticised complexity of the accounting standards, with the patchwork of measurement methods and associated rules, should be reduced under IFRS9 by way of a principles-based approach that sets forth two central criteria for classifying financial assets (IFRS 9.4.1.1): first, the type of business model for managing the financial assets, and second, the contractual cash flow characteristics of the financial assets. This is based on the notion that, for users of financial statements, the usefulness of the information provided by the various measurement methods depends on the manner in which an entity generates revenue using its assets. Representatives from credit institutions, especially, argued that the accounting standards ought to take account of cases in which financial instruments are held, for example, with the aim of collecting interest payments that are fixed when the contract is concluded. In such cases, they claimed, it was questionable whether fair value accounting, for example, provided users with relevant information.

As a result, IFRS9 continues to classify financial assets in a number of measurement categories in which different methodologies are used to determine their carrying amounts (“mixed attribute approach”). The main change is that, in principle, only the two classification criteria mentioned above are to be assessed.

Traditional lending business classified in “Amortised cost” category

Where financial assets are held in order to collect their contractual cash flows and these are solely payments of principal and interest, they are to be assigned to category (1) “Amortised cost (AC)”. IFRS9 mentions a basic lending arrangement as one example of this type of financial instrument. For this reason, credit institutions’ traditional lending business typically falls under this measurement category.

New classification rules for financial assets

Business model/cash flows	Measurement category
(1) Collection of contractual cash flows that are solely payments of principal and interest	Amortised cost (AC)
(2) Both collection of contractual cash flows that are solely payments of principal and interest as well as sales are integral to the business model	Fair value through other comprehensive income (FVOCI – with recycling) ¹
(3) Equity instruments not held for trading (optional category)	Fair value through other comprehensive income (FVOCI – without recycling) ¹
(4) Mainly trading and/or contractual cash flows that are not solely payments of principal and interest	Fair value through profit or loss (FVPL)

¹ “Recycling” refers to the reclassification of the fair value gain or loss from other comprehensive income to profit or loss when a financial instrument is derecognised.

Deutsche Bundesbank

If, alongside the collection of contractual cash flows, the sale of financial assets with corresponding cash flow characteristics is also an integral part of an entity’s business model, the financial assets are to be categorised under (2) “Fair value through other comprehensive income (FVOCI) – with recycling”. In addition, since the contractual cash flows from the assets in this category are solely payments of principal and interest, interest revenue calculated using the effective interest method is recognised in profit or loss. Securities held in the liquidity reserve, for example, can be allocated to this category.

“Fair value through other comprehensive income” category relevant to liquidity reserves

As a general rule, equity instruments cannot be assigned to categories (1) “Amortised cost” or (2) “FVOCI – with recycling” as their cash flows, by definition, are not payments of principal and interest. For equity instruments not held for trading, however, IFRS9 does offer entities the option of assigning them to category (3) “Fair value through other comprehensive income

Option for strategic investments

(FVOCI) – without recycling”. The IASB has said that it added this option because users of financial statements assess the fair value changes of equity instruments differently depending, for example, on whether the instruments are intended to serve as a strategic investment or to generate short-term gains. By presenting fair value gains and losses separately in other comprehensive income (OCI), it should therefore be easier to assess changes in the fair value of equity investments not held for trading. Recycling of fair value gains and losses into profit or loss is prohibited as, according to the IASB, this would create the need to routinely assess these equity investments for impairment, and it was precisely the impairment rules for equity instruments that had been criticised during the financial crisis for being subjective. The IASB has opted to proceed pragmatically on this score.

FVPL as a residual category

The residual measurement category under IFRS 9 is category (4) “Fair value through profit or loss (FVPL)”. At the onset of the debate regarding overhauling the accounting standards, the IASB still held the opinion that fair value was the only measurement attribute that was appropriate for all types of financial instruments. However, there was opposition to expanding fair value accounting, including from the Basel Committee on Banking Supervision, which argued that a large proportion of business is not managed on the basis of fair value, especially among smaller credit institutions. As a compromise, IFRS 9 therefore contains provisions to identify assets for which relevant and useful information can be obtained by measuring them using the effective interest method. The only assets to be recognised at fair value through profit or loss (FVPL) are those which cannot be assigned to any of the other categories (1 to 3) due to the entity’s business model and/or the characteristics of their cash flows. One example of this is financial assets held for trading, which, by definition, also include derivatives.

Fair value option remains

Besides classifying financial assets based on the two criteria mentioned above, IFRS 9 retains

the option of designating financial assets upon initial recognition as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an accounting mismatch. By contrast, the IASB concluded that the fair value option was unnecessary for financial assets managed on a fair value basis or for those with embedded derivatives because IFRS 9 requires these assets to be assigned to category (4) “Fair value through profit or loss (FVPL)”.

IFRS 9 does not include any principles comparable to those for financial assets for the classification of financial liabilities. Instead, the previous accounting rules were left largely unchanged, with the result that measurement at amortised cost is the default (IFRS 9.4.2.1). Liabilities held for trading, including all derivative liabilities and liabilities for which the fair value option is exercised, are subject to FVPL accounting. Concerning the fair value option, IFRS 9 introduced the requirement to present in OCI the amount of change in the fair value of a financial liability that is attributable to the change in the reporting entity’s own credit risk.

In summary, while IFRS 9 does not reduce the number of accounting methods for financial instruments in any great way, its principles-based approach to classifying assets does introduce a stringent concept which replaces much of the complex and unclear rules-based requirements that were in place previously. From the perspective of banking supervision, clear and consistent implementation of this new concept is vital, since classification determines how the risks arising from financial assets affect the balance sheet. In category (1) “Amortised cost”, impairments of financial assets are only recognised if they are the result of credit risk. Changes in value caused by market risk, by contrast, continue to be disregarded.³ Market risk is, however, relevant when financial instruments are leveraged or to be sold, which can

Minimal changes in liabilities accounting

Welcome new concept

³ While foreign exchange rate risk is one type of market risk, it is not covered in this article.

expose the expected cash flows to negative factors. These financial instruments are therefore excluded from amortised cost accounting. Impairments resulting from credit risk are recognised according to the impairment requirements described below.

Loss allowances based on expected credit losses

ECL model for impairment

Under IFRS 9, loss allowances are established on the basis of a model that recognises expected credit losses (ECL model). The ECL model differs fundamentally from previous practice under IAS 39, where the incurred loss approach only required allowances to be recognised after a loss event had taken place.

Uniform and symmetrical application of new requirements

The new requirements apply to financial assets in categories (1) "Amortised cost" and (2) "FVOCI – with recycling", and to lease receivables, loan commitments and financial guarantee contracts. The introduction of a single impairment model for these financial instruments marks a major improvement over the IAS 39 regime, which had multiple impairment models for the various measurement categories and had therefore been criticised for its complexity. IFRS 9 now requires the three-stage model depicted overleaf to be applied uniformly to all these financial instruments and a loss allowance to be recognised through profit and loss at each reporting date. The stage to which a financial instrument is assigned depends on how its credit risk has evolved since initial recognition. The criteria for transferring a financial instrument from one stage to another are to be applied symmetrically – in other words, all else being equal, deteriorations in credit quality should prompt a transfer to a higher stage just as improvements in credit quality should result in a transfer to a lower stage.

Recognition of 12-month ECL at stage 1

Stage 1 comprises all financial instruments whose credit risk has not increased significantly since their initial recognition. A loss allowance equal to the 12-month expected credit losses

(12-month ECL) needs to be recognised for each of these financial instruments. The 12-month ECL represent the credit losses arising from a potential debtor default within the next twelve months, weighted by the respective risk of a default occurring.⁴ Interest revenue from financial assets at this stage is calculated on the basis of the gross carrying amount.

Stage 2 of the new impairment model comprises all financial instruments whose credit risk has increased significantly since their initial recognition. To determine whether credit risk has increased significantly, the risk of a default occurring over the remaining lifetime of the financial instrument is compared with the risk of a default occurring that was originally expected for the same time period when the financial instrument was initially recognised (forward probability of default, or forward PD).⁵ It is appropriate for this comparison to also consider the absolute change in the risk of a default occurring in order to avoid overlooking a significant increase simply because the change does not appear significant in relation to an already high level of credit risk.

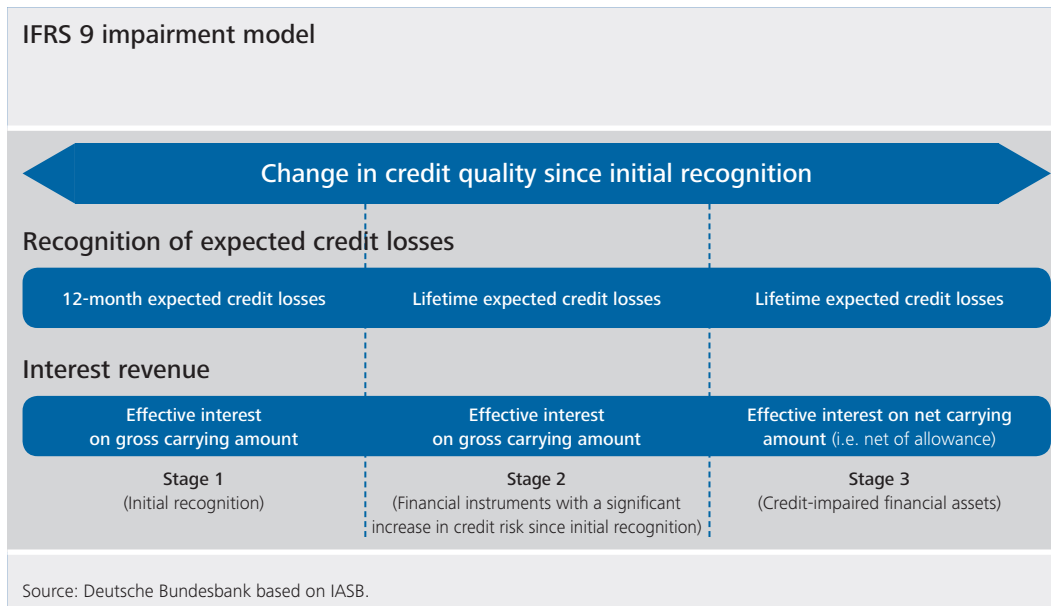
For stage 2 financial instruments, credit institutions recognise loss allowances at an amount equal to the lifetime expected credit losses (lifetime ECL). These are the credit losses arising from a potential debtor default over the financial instrument's lifetime weighted with the risk of a default occurring. In the IASB's view, recognition of lifetime ECL is appropriate here because a significant increase in credit risk means that an economic loss has been incurred. This loss is caused by the fact that, for most financial instruments, the interest rate, and especially the credit risk premium, are not adjusted to changes in the credit risk during their life-

Significant increase in credit risk triggers transfer to higher stage

Recognition of lifetime ECL at stage 2

⁴ In other words, the lifetime expected credit losses (discounted difference between contractual and expected cash flows) are weighted with the probability of a loss event occurring within the next twelve months.

⁵ A simple comparison with the risk of a default occurring over the total expected lifetime as at initial recognition is not sufficient as the risk of a default occurring over the remaining lifetime typically diminishes over time.



time. In the event of a significant increase in credit risk, it is therefore not appropriate to use the 12-month ECL as a proxy for the expected credit loss, and lifetime ECL should be used instead.

carrying amount would no longer faithfully represent the economic return. For the same reason, interest revenue from impaired financial assets was already calculated on the basis of the net carrying amount under IAS 39.

Stage 3 similar to IAS 39 impairment model

Finally, stage 3 of the ECL model comprises credit-impaired financial assets. A significant deterioration in the credit quality of these assets is observable in that one or more serious events have occurred that have had a detrimental impact on the estimated future cash flows of those assets. The examples of such events listed in IFRS 9 are much the same as the examples of loss events in IAS 39 and include, for example, significant financial difficulty of the debtor, and interest or principal payments that are substantially past due.

Reporting entities are required to recognise loss allowances at an amount equal to lifetime ECL for stage 3 financial assets. However, unlike at stages 1 and 2, interest revenue is calculated on the basis of the net carrying amount, i.e. the exposure amount net of loss allowances. The reason for this change in calculation methodology is that, following the significant increase in credit risk, the gap between the contractual payments and the payments that are actually expected becomes so wide that calculating interest revenue on the basis of the gross

When measuring the loss allowances at the various stages, and when determining a significant increase in credit risk, reporting entities are to consider all reasonable and supportable information that is available without undue cost or effort.⁶ Unlike under IAS 39, this wide range of information also includes forward-looking data such as forecasts of future economic conditions. IFRS 9 expects reporting entities to reflect this forward-looking information in scenario analyses that are used when calculating the amount of the loss allowances. At least one scenario should consider the possibility that a credit loss occurs. Beyond these requirements, reporting entities are generally free to choose the methods they use to calculate loss allowances and identify significant increases in credit risk.⁷

Wide range of information taken into consideration

⁶ See, for example, IFRS 9.5.5.11.

⁷ Credit institutions, however, face further supervisory expectations for the implementation of ECL models, which were formulated in guidelines issued by the Basel Committee on Banking Supervision and the European Banking Authority (EBA). For more information on this, see the section entitled "Regulatory guidelines on accounting for expected credit losses" on pp. 84 ff.

Hedge accounting

Hedge accounting requirements overhauled

In the area of hedge accounting, the IASB sought to develop a more principles-based approach and align the accounting requirements more closely with risk management practice. One major innovation is that effectiveness testing has been made more flexible. The time-consuming requirement to demonstrate that micro hedges always are within the 80% to 125% effectiveness range has been removed. Instead, hedge effectiveness is assessed on the basis of an economic analysis that uses internal risk management data.⁸

Critical appraisal of new accounting requirements

Banking supervisors welcome timely processing of information and early provisioning

The key features of IFRS 9 are the requirement to take forward-looking information into account and the introduction of stage 2 of the ECL model. From the perspective of banking supervisors, the early and – in comparison to IAS 39 – “additional” recognition of loss allowances is generally to be welcomed. Credit institutions are now required to reflect relevant information about changes in credit risk in their financial statements in a timely manner and therefore also take it into account when calculating their regulatory capital.

Considerable scope for discretion nevertheless

What is problematic is the considerable discretionary leeway which the new ECL model in particular brings for reporting credit institutions. For instance, the credit institutions themselves get to determine when there has been a significant increase in credit risk. The IASB consciously avoided writing a specific requirement as credit risk is calculated using different methods and a blanket requirement cannot properly reflect the differences between the various types of firms, sectors and geographical regions. Credit institutions can likewise use a great deal of judgement when it comes to calculating credit risk, such as the manner in which they model risk parameters and select the underlying input factors. The estimation of

future cash flows is, by its very nature, another activity that is fraught with uncertainties, especially if it is to consider assumptions about future economic developments. Here, too, credit institutions can use their discretion in considering issues such as how historical loss experience is to be adjusted to future conditions and which indicators should be used as inputs when forecasting these future conditions. These numerous forms of discretionary scope give rise to the risk that, in practice, discrepancies will emerge in the implementation of IFRS 9, making it more difficult to compare one credit institution’s financial statements with another’s. This also impacts on the activities of banking supervisors, as their efforts to assess the risk situation include comparing and contrasting financial statements across credit institutions.

Challenges for credit institutions

Banking supervisors are keeping a very close eye on how credit institutions implement IFRS 9. They want to see that credit institutions have adequate processes in place for establishing appropriate levels of loss allowances⁹ and that accounting standards are implemented such that they are able to assess institutions on as level a playing field as possible. For this reason, banking supervisors in Europe conducted a series of projects on IFRS 9 with a view to fostering the consistent implementation of the standard. These initiatives explored which parts of the new accounting requirements come with specific challenges for credit institutions and how key prudential metrics are expected to be affected.

Banking supervisors monitoring implementation of IFRS 9 closely

⁸ One item still on the agenda is the revision of the accounting rules governing the dynamic risk management of open portfolios (macro hedging), which is a particularly relevant topic for credit institutions. As long as this project has not been finalised, reporting entities may elect to continue applying the hedge accounting requirements of IAS 39 in their entirety.

⁹ See Basel Committee on Banking Supervision (2012), Core Principles for Effective Banking Supervision, Principle 18. Available at <https://www.bis.org/pub/bcbs230.pdf>

Data quality and availability the greatest challenges

In two joint impact assessments by the EBA and national supervisory authorities, 58 institutions were surveyed at year-end 2015, and 54 at year-end 2016, regarding the stage of implementation and the impact of IFRS 9.¹⁰ The institutions surveyed in both studies pointed to insufficient data quality in some cases and a lack of data for determining a significant increase in credit risk and for calculating expected credit losses as the greatest challenges. Moreover, many institutions reported that they leveraged regulatory models to estimate expected credit losses, yet adapting these to incorporate forward-looking information was a complex task. In consideration of these and other observations, the EBA issued a number of recommendations it believes to be key to robust implementation of IFRS 9. One such recommendation highlights the importance of applying a consistent methodology when making use of approximations for accounting purposes.

With regard to the expected impact on the prudential metrics, the surveyed institutions reported that the new impairment requirements resulted in a reduction of the Common Equity Tier 1 (CET1) capital ratio. Institutions across Europe expected an average decline in the CET1 capital ratio of 45 basis points (in the first study: 59 basis points). One-quarter of the institutions surveyed even expected a decline of at least 75 basis points (in both studies). Loss allowances were expected to rise by an average of 13% (first study: 18%), with one-quarter of institutions projecting an increase of at least 18% (first study: 30%).

Significant institutions assessed by JSTs

Besides the EBA, the supervisory authorities that make up the Single Supervisory Mechanism (SSM) also investigated in 2017 how credit institutions were prepared for the application of IFRS 9 (ECB Thematic Review). This review covered 106 significant institutions (SIs) and 77 less significant institutions (LSIs).¹¹ The SIs were assessed in the first quarter of 2017 by the joint supervisory teams (JSTs), which considered the extent to which preparations for IFRS 9 were consistent with the predefined expectations of

supervisors. The SIs were informed in writing and during the supervisory dialogue of any findings and remedial actions, and the JSTs also followed up on outstanding issues from the Thematic Review after IFRS 9 came into effect in 2018. LSIs were investigated using self-assessments based on the EBA's impact assessment exercises. All the institutions surveyed felt the greatest challenge to be the implementation of the new impairment regime, where supervisors noted, amongst other things, the insufficient documentation on the processes for including forward-looking information, plus room for improvement in developing the validation and back-testing processes. The SIs calculated that the expected quantitative impact of IFRS 9 would push down the CET1 capital ratio by 40 basis points on average, with around one-quarter of the institutions estimating an effect of at least 50 basis points. The LSIs, meanwhile, forecasted a reduction of 59 basis points, although this number was heavily influenced by negative outliers as more than three-quarters of these institutions reported that they were only expecting a decline of 25 basis points at most.

The actual impact on own funds and loss allowances

Most of the studies available thus far were carried out before IFRS 9 was applied for the first time, meaning that they are only based on estimations. Since 1 January 2018, however, credit institutions have had to implement the new standard in their actual accounting practices. The Bundesbank has analysed how the initial application of IFRS 9 has impacted on those German credit institutions which prepare

Analysis of real data possible for the first time

¹⁰ These impact assessments are available at [https://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+impact+assessment+of+IFRS+9+\(first+study\)+and+https://www.eba.europa.eu/documents/10180/1720738/EBA+Report+on+results+from+the+2nd+EBA+IFRS+9+IA.pdf](https://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+impact+assessment+of+IFRS+9+(first+study)+and+https://www.eba.europa.eu/documents/10180/1720738/EBA+Report+on+results+from+the+2nd+EBA+IFRS+9+IA.pdf) (second study).

¹¹ The ECB published the results of its Thematic Review in November 2017; the review itself is available at https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2017/ssm.reportlsi_2017.en.pdf

their financial statements in conformity with IFRSs.

Sample represents lion's share of IFRS institutions

In Germany, a total of 24 credit institutions were preparing their consolidated financial statements in conformity with IFRSs at the end of 2017. The sample examined excludes 11 institutions that were either a subgroup of another institution already included in the sample, or because their size and business model had negligible significance for the banking market, or because they were undergoing a substantial restructuring process. The final sample comprises 13 institutions which were assessed at the highest level of consolidation in Germany. These institutions' aggregate total assets amounted to around €4.25 trillion, equivalent to around 94% of the consolidated total assets of the German credit institutions that prepare their financial statements in conformity with IFRSs. Data on the impact of first-time application of IFRS 9 on these selected institutions were gathered from their published consolidated financial statements and Pillar 3 disclosure reports for 2017 and from their semi-annual financial reporting as at 30 June 2018. Where data were not publicly available, the institutions were asked to provide internal figures.

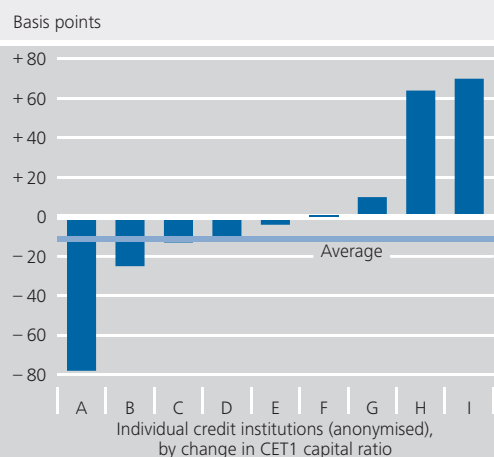
Impact on CET1 capital ratio moderate

To determine the overall impact of IFRS 9, Bundesbank analysts compared the institutions' CET1 capital ratios as at 31 December 2017 and 1 January 2018 without application of the supervisory transitional arrangements permitted under the European Capital Requirements Regulation (CRR) ("fully loaded").¹² Since the relevant data were lacking for four of the institutions as per at least one of the reporting dates, this part of the investigation only touches on nine institutions. The Bundesbank found that first-time application of IFRS 9 reduced the "fully loaded" CET1 capital ratio by just 11 basis points on average.¹³

Reclassifications increase CET1 capital ratio for some institutions

The chart above shows that the change in the "fully loaded" CET1 capital ratio in the sample has a wide margin, ranging from a drop of 80 basis points to an increase of 70 basis points.

Change in Common Equity Tier 1 (CET1) capital ratio due to IFRS 9



Deutsche Bundesbank

One notable reason why some institutions saw their CET1 capital ratios increase is that financial assets are measured at fair value under IFRS 9, but at amortised cost under the previous regime.¹⁴ For the bulk of the institutions under review, the "fully loaded" CET1 capital ratio fell only marginally, if at all, on 1 January 2018. There are, however, also isolated cases in which this key prudential metric comes under more distinct pressure, as had been projected ahead of IFRS 9 implementation, especially on account of the new impairment regime, for European credit institutions in the investigations by the EBA and the ECB.

Information on the impact of the new impairment regime was provided by all 13 institutions in the sample. First-time application of IFRS 9 increased loss allowances by 5.9% on average.¹⁵ How each institution fared is shown in the chart on p. 84, which indicates that loss

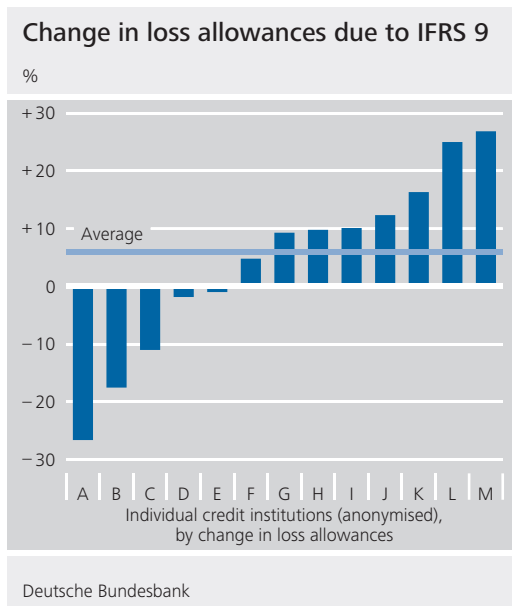
Loss allowances up under IFRS 9

¹² The "fully loaded" CET1 capital ratio is used here because various transitional arrangements under the CRR expired at the start of 2018. Comparing the CET1 capital ratios with these transitional arrangements factored in would bias the results on the impact of IFRS 9.

¹³ The average value was determined by weighting it with total assets as calculated according to the HGB.

¹⁴ Reclassification to a fair value category leads to the recognition of hidden reserves if the fair value of financial assets is higher than their previous carrying amount.

¹⁵ The average value was determined by weighting it with total assets as calculated according to the HGB.



allowances decreased in some cases. This outcome is notably due to the fact that the Bundesbank's analysis looks at the net change in loss allowances, which includes the impact from both the new ECL model and changes in the stock of financial assets which are subject to the impairment requirements. Because of the new classification approach, some institutions have reclassified financial assets to the FVPL category, which covers, for instance, shipping loans that are now to be sold if a favourable opportunity were to arise. No loss allowances need to be recognised under the ECL model for financial assets classified to the FVPL category; instead, changes in value are recognised directly in the assets' fair values. However, the reversal of loss allowances as a result of reclassifications should not generally cause an increase in equity as the circumstances that led to loss allowances being set aside in the first place reduce the fair value at the same time.¹⁶

All in all, the actual impact of IFRS9 is moderate for most of the 13 German institutions that were examined. The effect on the CET1 capital ratio and the change in allowance levels are lower than the figures forecast by the European institutions in the earlier impact assessment exercises by the EBA and the ECB.

Impact lower than in comparable European studies

Regulatory guidelines on accounting for expected credit losses

One cornerstone of the various assessments performed by German and European authorities in the context of IFRS9 was the supervisory expectations regarding the implementation of the new ECL accounting requirements, which have been set out by the Basel Committee on Banking Supervision. The Committee looked at the standard in great detail immediately after it was finalised with the purpose of mapping out ways to promote consistent implementation of the new rules. The outcome of these deliberations saw the Committee update its guidelines on sound credit risk assessment and valuation for loans from 2006 and rename them "Guidance on credit risk and accounting for expected credit losses".¹⁷

Implementation of new ECL requirements of particular interest to banking supervisors

Published in December 2015, the revised guidelines articulate supervisory expectations with regard to credit risk management processes and procedures as a basis for determining ECL allowances. They draw special attention to the need for robust consideration of relevant, reasonable and supportable forward-looking information as the key component of ECL accounting models. Particular emphasis is also placed on the responsibility of the board and management, both of whom are responsible for ensuring that their institution has appropriate credit risk practices (including an effective system of internal control) to consistently determine adequate loss allowances in accordance with the applicable accounting framework and relevant supervisory guidance. Other specific expectations address, amongst other things, the credit risk rating process, the group-

The Basel "Guidance on credit risk and accounting for expected credit losses" ...

¹⁶ That said, it is theoretically conceivable, where fair value measurement is applied, that impairments caused by credit risk will be more than offset by the fact that the general market interest rate level is significantly below the contractual interest rate of the assets, meaning that, overall, their fair value is higher than their amortised cost, resulting in an increase in equity due to reclassification.

¹⁷ The Basel Committee's "Guidance on credit risk and accounting for expected credit losses" are available at <https://www.bis.org/bcbs/publ/d350.pdf>

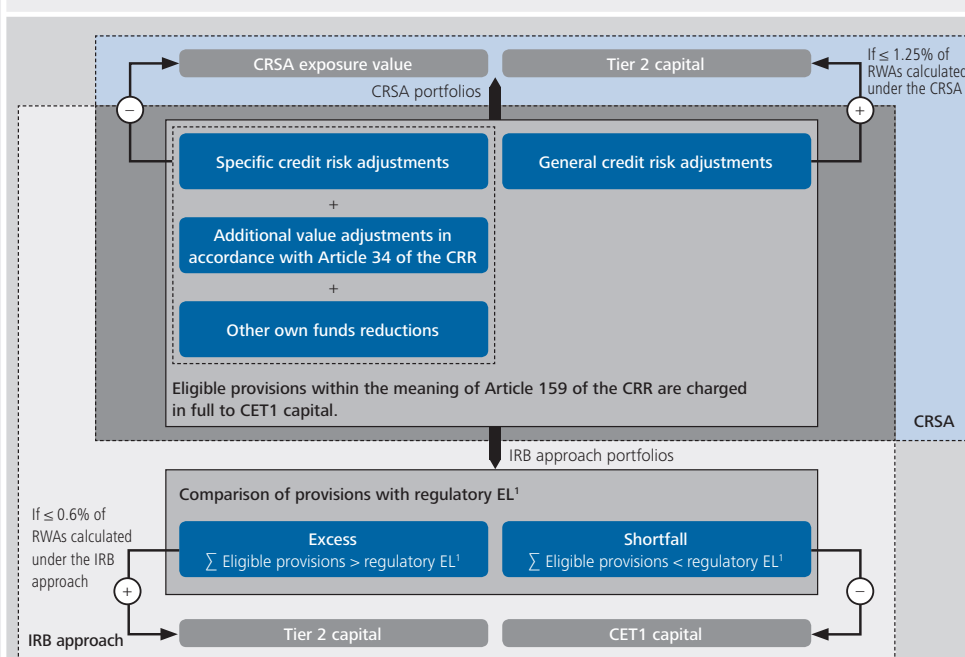
Current regulatory treatment of accounting loss allowances

There are around 40 credit institutions in Germany – mostly large ones – that use the internal ratings-based (IRB) approach. This approach allows credit institutions to calculate their capital requirements for credit risk based on their own internal parameter estimates. These estimates are needed for the calculation of the regulatory expected loss (regulatory EL) amount, which serves, on the one hand, as a credit risk provisioning floor and, on the other, as an input in the calculation of risk weights. However, the approach applied exclusively by the majority of credit institutions is the simpler standardised approach for credit risk (CRSA), where no regulatory EL amount is determined and risk weights are calibrated by banking supervisors. Unsurprisingly, then, the IRB approach and the CRSA differ in a number of ways in terms of their conceptual basis

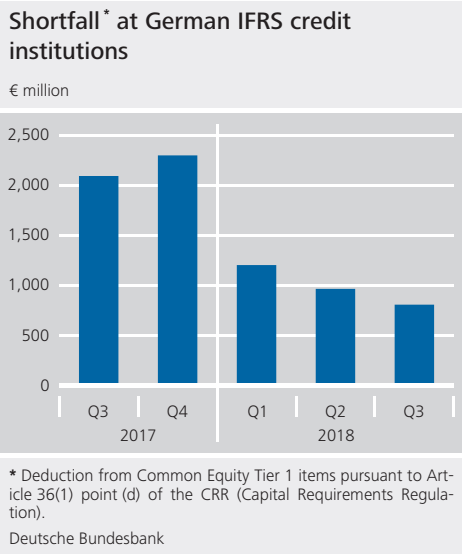
and design, including how they each treat accounting loss allowances (provisions).

The CRSA makes a distinction between specific and general credit risk adjustments. Specific credit risk adjustments are deducted from the exposure value, so the higher the accounting loss allowances in the form of specific credit risk adjustments, the lower the risk-weighted assets (RWAs). By contrast, general credit risk adjustments do not reduce RWAs but can be included in Tier 2 capital, though only up to 1.25% of the RWAs calculated under the CRSA. In this context, it is particularly worth noting that the definitions of specific and general credit risk adjustments are partly decoupled from the common accounting terminology. That is to say, accounting loss allowances are mapped to general or specific credit risk

Regulatory treatment of accounting provisions at a glance



¹ Regulatory expected loss.



adjustments in accordance with criteria determined by regulators. Individual, general and collective loss allowances are thus generally considered specific credit risk adjustments under EU law. Only provisioning amounts that are freely and fully available, as regards to timing and amount, to meet credit risk losses that have not yet materialised may be considered general credit risk adjustments. Under the German generally accepted accounting principles (GAAP), the freely available part of the reserve for general banking risks pursuant to Section 340f. of the Commercial Code (*Handelsgesetzbuch*) is one example of a general credit risk adjustment. However, credit institutions often decide to not have their undisclosed reserves counted as Tier 2 items, since this would effectively require disclosure of these reserves in their Pillar 3 reports.

Under the IRB approaches, meanwhile, the entire stock of accounting loss allowances for credit risk – that is, specific and general credit risk adjustments alike – is deemed eligible for the comparison with the regulatory EL amount. As mentioned above, regulatory EL represents the floor for backing credit risk with own funds. This is why a credit institution whose eligible provisions

are lower than its regulatory EL is required to deduct the resulting shortfall directly from its Common Equity Tier 1 (CET1) capital. If the opposite is the case – that is, the comparison of eligible provisions with the regulatory EL amount reveals an excess of provisions, regardless of whether they are considered specific or general credit risk adjustments – an institution is permitted to include the excess amount in its Tier 2 capital up to a limit of 0.6% of the RWAs calculated under the respective IRB approach.

The evolution of the aggregate shortfall under IFRS9 has been analysed for a sample of ten credit institutions that prepare their financial statements according to International Financial Reporting Standards (IFRSs) and that reported a shortfall at least once between September 2017 and September 2018. The aggregate shortfall declined noticeably over this horizon, falling from €2.1 billion at the end of September 2017 to €805 million at the end of September 2018. Evidently, then, the difference between eligible provisions and the regulatory EL amount has decreased significantly in size. The observed increase in loss allowances following the initial application of IFRS9 suggested that such a decline would occur. The shortfall that still remains can be put down to the unique design and technical features of the approaches used to determine this measure.

ing of similar lending exposures and the validation of impairment models.

... also includes specific supervisory expectations for accounting under IFRS 9

The scope of the Basel guidance primarily covers internationally active credit institutions for which the use of ECL models is mandatory on account of the accounting framework that applies to them. Consequently, these supervisory expectations are, in principle, relevant to preparers of IFRS and US GAAP accounts alike.¹⁸ The guidance does, however, also contain an appendix with supervisory expectations specific to credit institutions reporting under IFRSs. This appendix formulates more detailed supervisory expectations regarding the measurement of 12-month ECL, the assessment of significant increases in credit risk, and the use of “practical expedients” under IFRS 9. In some cases, the Basel Committee interprets the IASB’s requirements in a conservative manner, thus signalling that credit institutions must meet the highest quality standards when implementing IFRS 9 in order to satisfy supervisory expectations.

Basel guidelines incorporated into EU framework

In May 2017, the EBA incorporated the Basel Committee’s guidelines into guidelines of its own¹⁹ and called on Member States to implement them in their national law via the “comply or explain” mechanism. The ECB has declared its intention to comply with the EBA guidelines for its jurisdiction – SIs in the euro area. For its part, the Federal Financial Supervisory Authority (BaFin), in its capacity as Germany’s national competent authority for LSIs, saw no need to specify the Minimum Requirements for Risk Management (MaRisk) in response to the EBA guidelines because the latter are largely geared towards IFRS standards, while the vast majority of LSIs in Germany prepare their financial statements according to national GAAP (HGB).

Impact of IFRS 9 on the prudential capital requirements for credit risk

Two regulatory approaches are permitted for calculating the prudential capital requirements for credit risk – the standardised approach for credit risk (CRSA) and the internal ratings-based (IRB) approach. With IFRS 9 coming into force from 2018 and the US GAAP “current expected credit losses” (CECL) standard becoming applicable as of 2020, the Basel Committee investigated how the new ECL accounting frameworks interact with the relevant rules under the CRSA and IRB approach, and published its preliminary deliberations for consultation at the end of 2016.²⁰ The standard “Regulatory treatment of accounting provisions – interim approach and transitional arrangements”²¹ was then published in March 2017, communicating two decisions of the Committee.

Banking supervisors exploring interaction between accounting rules for ECL and capital requirements for credit risk

The first of these decisions is that the existing regulatory treatment of loss allowances will be retained at least until the interaction between the capital requirements and the ECL accounting frameworks has been subjected to a thorough conceptual and quantitative analysis. Under this “interim solution”, jurisdictions would extend their existing approaches to categorising loss allowances as specific or general credit risk adjustments, which is of particular relevance for the CRSA, to loss allowances for

Status quo to be maintained as an “interim solution”, at least for the time being

¹⁸ The new “current expected credit loss” impairment standard under US GAAP, applicable from 2020, also requires the recognition of expected credit losses. However, unlike IFRS 9, loss allowances will be based solely on lifetime ECL.

¹⁹ The EBA’s “Guidelines on credit institutions’ credit risk management practices and accounting for expected credit losses” are available at <https://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-credit-institutions-credit-risk-management-practices-and-accounting-for-expected-credit-losses>

²⁰ Two documents are concerned here: the consultative document “Regulatory treatment of accounting provisions – interim approach and transitional arrangements” (available at <https://www.bis.org/bcbs/publ/d386.pdf>) and the discussion paper “Regulatory treatment of accounting provisions” (available at <https://www.bis.org/bcbs/publ/d385.pdf>).

²¹ The Basel standard is available at <https://www.bis.org/bcbs/publ/d401.pdf>

IFRS 9 transitional arrangements in the European Capital Requirements Regulation (CRR)

Based on high-level requirements set out by the Basel Committee, Regulation (EU) 2017/2395 effective as of 27 December 2017 amended the European Capital Requirements Regulation (CRR) as regards transitional arrangements for International Financial Reporting Standard (IFRS) 9. This transitional rule can be found in Article 473a of the CRR. Institutions that prepare their accounts in conformity with IFRSs, institutions that apply IFRSs voluntarily for supervisory reporting purposes pursuant to Article 24(2) of the CRR, and institutions that apply national generally accepted accounting principles (GAAP) which require the recognition of loss allowances on the basis of expected credit losses (ECL) all fall within the scope of these transitional arrangements.

Application of the transitional arrangements is optional. Institutions were given until 1 February 2018 to notify their competent authority whether they wish to apply the arrangements. Where an institution has received the prior permission of the competent authority, it may reverse once, during the transitional period, its initial decision.

Specifically, institutions are permitted, over a five-year transitional period starting in 2018, to add back to their Common Equity Tier 1 (CET1) capital a portion of the additional loss allowances (provisions) incurred due to application of ECL accounting.

This capital add-back needs to be calculated separately for portfolios under the standardised approach for credit risk (CRSA) and the internal ratings-based (IRB) approach in order to ensure that only provisions in excess of the regulatory expected loss (EL) are included in own funds. Furthermore, the add-back amount is made up of a static and a dynamic component, with institutions having the option to deselect the latter. The idea behind the static component is to mitigate the increase in loss allowances resulting from day one application of IFRS 9 at the effective date of transition from International Accounting Standard

(IAS) 39 to IFRS 9. The dynamic component serves to dampen the potential subsequent impact in future periods, but it is confined to loss allowances for non-defaulted exposures.

The phase-in factors applied to the provisioning amounts which can be added back will decrease over time – 95% in 2018, 85% in 2019, 70% in 2020, 50% in 2021, and 25% in 2022. It should be noted that institutions are permitted to almost fully neutralise the impact of transitioning to the new impairment regime during the first transition period. This compromise was reached in the European negotiations on the design of the transitional arrangements as a step towards creating a level playing field for IFRS and US GAAP institutions.

To prevent institutions from benefiting twice from the provisioning adjustments, these shall be effected in a consistent manner under the regulatory regime, which – besides adjustments to CET1 capital – also necessitates changes to other regulatory items that are impacted directly or indirectly by the “adjusted” provisions. This calls for a number of adjustments, in particular to the capital deductions for deferred tax assets, the (CRSA) exposure values and the provisions included in Tier 2 capital.

Whether an institution decides to apply the transitional arrangements or not, in the interests of market transparency it must communicate its decision in the regulatory Pillar III report. Institutions that decide to apply the IFRS 9 transitional arrangements are furthermore required to calculate and disclose all capital ratios and the leverage ratio both with and without the application of Article 473a of the CRR.

Currently, the German credit institutions are not making use of the transitional arrangements, but a survey by the European Banking Authority (EBA) has found that 56% of EU institutions are doing so.

ECL. As a result, and based on EU rules as they currently stand, the EBA published an Opinion which clarifies that all three stages of the IFRS 9 impairment model constitute specific credit risk adjustments.²² Credit institutions that prepare their financial statements in conformity with IFRSs are now expected to comply with this stipulation. That said, the treatment of fair value adjustments has not yet been fully clarified.

A regulatory transitional period ...

The second decision sets out a framework for transitional arrangements. Under this framework, it is permissible (as an option) to phase in the impact of the new ECL accounting rules on CET1 capital as long as the transitional period does not exceed five years and certain other requirements are respected. To date, only the EU has made use of this option, though the supervisory authorities in the United States are also currently discussing the introduction of a regulatory transitional period for the US CECL standard.

... will also be used by supervisors to gain experience with ECL accounting models

Given the uncertainties associated with the (first-time) implementation of the new and far more complex impairment models, the aforementioned transitional arrangements were set up as a kind of regulatory hedge against the possibility of a sudden and significant reduction of CET1 capital as a result of switching from incurred loss provisioning to ECL provisioning. During the transitional phase, supervisors can gain experience with the new accounting requirements and how they are implemented by the institutions – experience which will ultimately be needed to make a well-informed decision on whether the existing rules on the regulatory treatment of accounting loss allowances are appropriate.

Possible effects on business models and the stability of credit institutions

One topic raised while the accounting rules were being revised concerned the extent to

which the ECL model under IFRS 9 might impact on loan maturities. The European Systemic Risk Board (ESRB) addressed this issue in its “Financial stability implications of IFRS 9” report.²³ In this paper, the ESRB describes the possibility that institutions might shorten the maturities of their loans because the shorter the loan maturity, the lower the lifetime ECL they would need to recognise as a loss allowance in the event of a significant increase in credit risk. Note that this incentive will probably be weaker as long as financial instruments are assigned to stage 1 on account of the shorter, 12-month ECL observation period.

Shorter maturities in new business possible

One of the most controversial issues at the moment is the potential procyclicality of ECL impairment models.²⁴ The new stages 1 and 2 under IFRS 9 encourage credit institutions to recognise loss allowances at an early stage. This expedites the processing of relevant information on credit quality as well as on the associated expected credit losses, and this is generally to be welcomed. However, the ESRB writes in its “Financial stability implications of IFRS 9” report that this could cause procyclicality, especially if exposures are systematically shifted from stage 1 to stage 2. In the ESRB’s view, these shifts to stage 2 could occur on a major scale at a large number of institutions simultaneously if economic conditions deteriorated, pushing up borrower default rates. This could significantly increase the need for additional loss allowances and also put a strain on capital, potentially triggering a credit crunch and thereby exacerbating the economic downturn.

Procyclicality still on the table

²² The EBA’s Opinion is available at <https://www.eba.europa.eu/-/eba-publishes-opinion-on-transitional-arrangements-and-credit-risk-adjustments-due-to-the-introduction-of-ifrs-9>

²³ This report is available at https://www.esrb.europa.eu/pub/pdf/reports/20170717_fin_stab_imp_IFRS_9.en.pdf

²⁴ This can be understood as mutually reinforcing feedback mechanisms between the financial and real sectors of the economy. See Financial Stability Forum (2009), Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System, p. 8. Available at http://www.fsb.org/wp-content/uploads/r_0904a.pdf

One point that speaks against potential procyclicality is that, at the lowest point of a recession, IFRS 9 could lead to the early reversal of loss allowances if expectations regarding macroeconomic conditions and the individual borrower's credit risk have improved. What counts here is that such expectations are not overly optimistic. In this case, the onus might be on banking supervisors to impose supervisory measures in the form of capital add-ons, for instance.

■ Conclusion and outlook

IFRS 9 ranks as the most significant conceptual change in how financial instruments are accounted for since it became mandatory for publicly traded entities to prepare their financial statements in conformity with IFRSs. Recognition of expected credit losses in the new impairment model puts into practice one of the G20's main demands for a wider range of information to be incorporated into accounting.

At this stage, it is not possible to make a clear statement on the long-term material impact of the new standard going forward. In the short term, the biggest challenge for banks and supervisors will continue to be that of ensuring the proper implementation of the revised framework, which will entail considerable changes in institutions' accounting processes and systems. Looking towards the medium and long term, the impact of IFRS 9 will need to be evaluated using quantitative data. It is for this reason that supervisors have stated that they are in favour of retaining the regulatory treatment of accounting loss allowances for the time being.

There is no immediate need for action with regard to accounting pursuant to the HGB, as this set of rules already implicitly contains the option of taking into account forward-looking components in the form of the prudence principle as well as the concept of setting aside general loss allowances.