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Regulatory Newsflash

IFRS 9 and Regulatory Capital | Double trouble

The Basel Committee on Banking Supervision (BCBS) has released two papers (a consultative document and a discussion paper) on how accounting provisions under IFRS 9 interact with Basel III.

What is IFRS 9?

IFRS 9 determines how firms should classify and measure financial assets and liabilities for accounting purposes. Crucially, the rules mark a fundamental shift in accounting credit impairment rules.

The standard, which officially takes effect in January 2018, requires firms to recognise impairment sooner and estimate lifetime expected credit loss (ECL) for a wider spectrum of assets. According to a recent Deloitte survey, four-fifths of EU banks expect their stock of impairment to rise under IFRS 9.

What has the BCBS said about IFRS 9?

Two consultation papers have been published in relation to implementing ECL under IFRS9:

1. A discussion paper setting out long-term policy options for moving to ECL provisioning; and
2. A consultative document proposing a transitional period in which banks can continue to use the current approach to provisioning for regulatory capital calculations.

Why might impairments rise under IFRS 9?

We anticipate three main drivers of higher impairment:

1. Banks raising accounting impairments for lifetime ECL on exposures that have had significant increase in credit risk but not yet incurred a loss;
2. IFRS 9 requires banks to recognise in their impairments the tendency of customers to draw down on undrawn credit lines as credit quality deteriorates;
3. Banks are expected to develop probability-weighted ECL estimates against a range of macroeconomic scenarios. This may result in an increase in impairment, depending on the scenarios and prevailing economic conditions.

The Day 1 and ongoing financial impact will be largely dependent on the bank's risk profile, regulatory permissions and accounting policies.

What is the impact of provisions on regulatory capital?

The current regulatory treatment of General and Specific Provisions depends on whether a bank uses the Standardised approach or Internal Ratings Based (IRB) approach for calculating regulatory capital.

Standardised approach: Exposures are measured net of specific provisions and gross of general provisions for calculating capital requirements. Further, Banks are permitted to include general provisions in Tier 2 capital up to a limit of 1.25% of credit risk weighted assets (RWAs). Specific provisions do not qualify for inclusion in Tier 2 capital.

IRB approaches: All exposures are measured gross of specific provisions and partial write-offs. The Basel II framework defines "total eligible provisions" under the IRB approaches as the sum of all provisions (e.g. specific provisions, partial write-offs and portfolio-specific general provisions such as country risk provisions or general provisions) that are attributed to exposures treated under the IRB approaches including any discounts on defaulted assets.

Under the IRB approaches, any shortfall between total eligible provisions and regulatory expected loss (EL) is deducted from Common Equity Tier 1 (CET1) capital, whereas any excess is added to Tier 2 capital, up to a limit of 0.6% of credit RWAs calculated under the IRB approach.

Under IFRS 9, a rise in impairment depletes the capital adequacy of banks that use the Standardised approach to credit risk, as the 1:1 reduction in capital arising from increased impairments is not offset by reduced RWAs. The result is less clear-cut for IRB banks, reflecting the more complex relationship between impairment and the outcomes of the IRB capital formula. A further complication for IRB banks will arise from the implementation of capital floors based on Standardised RWAs, as IFRS 9 is a further factor in the assessment of whether or not the floor will be binding.

These impacts could be particularly marked in a stress, which could result in banks requiring additional capital to cover potential downturn impacts.

The BCBS's papers: regulatory treatment of provisions and transitional arrangements

Regulatory treatment of provisions: This discussion paper is positioned as the start of a discussion process with the industry, proposing changes to the Standardised and potentially IRB approaches to credit risk. This means the much-craved period of stability of banks' capital treatment will be further delayed.

Possible options for treatment of provisions under regulatory capital are set out in the paper:

1. Retain the current treatment permanently, to accommodate difference in accounting practices across jurisdictions;
2. Introduce a universal and binding definition of General and Specific Provisions to reduce unjustified variation in regulatory practices;
3. Remove the distinction between General and Specific Provisions and introduce EL (and capital deduction of excess EL) into the Standardised approach framework.

Option 3 above is set out in significantly more detail than the other two options, with detailed tables of possible EL rates and indicative examples of how the calculation would work; this may indicate the BCBS has a preference for this approach.

The potential implications (aside from the effect of IFRS 9 on the value of provisions held) that Standardised banks should consider include:

- The need for additional data and calculation capabilities to bring EL into the regulatory capital calculation process;
- Possible capital reductions resulting from the EL: provisions shortfall deduction, particularly if the BCBS does not recalibrate Standardised risk weights - which it notes in the paper may be necessary; and
- New reporting requirements under Pillar 3, as the EL and ECL numbers will likely become part of Pillar 3 once implemented.

Transitional arrangements: This consultation paper sets out a number of reasons identified by the Basel Committee to introduce transitional arrangements for the impact of ECL accounting on regulatory capital. These include:

- The impact could be significantly more material than currently expected, resulting in an unexpected decline in capital ratios;
- The Committee has not yet reached a conclusion on the permanent interaction between ECL accounting and the prudential regime; and
- The two-year gap between the effective dates of the ECL accounting standards under IFRS 9 and the US GAAP equivalent, Current Expected Credit Loss (CECL).

The Consultative document suggests three transitional options:

1. Day 1 CET1 impact on capital could be spread over a number of years - this option could be subject to a materiality threshold;
2. CET1 capital adjustment linked to Day 1 proportionate increase in impairment, which would remain fixed throughout the transition period; and
3. Phased prudential recognition of IFRS 9 Stage 1 and 2 impairment, spreading recognition of Stage 1 and 2 impairments in CET 1 capital over a period (the document uses 4 years) to avoid a 'cliff effect' on implementation.

How is Deloitte making an impact in this area?

Deloitte is supporting a wide range of clients with their IFRS 9 transition. Given the effect of increased impairments on capital ratios for banks, the regulatory capital impact is inevitably a key area of focus in the current environment with stress testing an additional early area of focus.

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