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Better to be good and on time than perfect and late: replacing incurred loss by expected loss

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The new bank provisioning standards: Implementation challenges and financial stability implications
Keynote speech
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Ladies and Gentlemen,

I would like to thank Banco de Espana for inviting me to speak about the new accounting provisioning standard. It is a real pleasure to be here today with you and to have the opportunity to speak at this important conference.

In my contribution I will take a securities markets regulators' perspective to the implementation and enforcement of the new accounting standard IFRS 9 *Financial Instruments*. I will focus particularly on the new expected credit loss (ECL) provisioning model that this standard introduced. IFRS 9 introduced a new progressive but complex accounting provisioning model that is at the forefront of interest not only of investors but also banking supervisors and accounting enforcers.

The change of the impairment model from the incurred loss to the expected loss marks a new paradigm. In my view, this change, at least partially, addresses the long acknowledged deficiency of accounting standards ("too little too late") that manifested itself during the recent financial crisis and thus responds to the G20 mandate[1]. This new paradigm allows earlier recognition of losses and considers a broader range of forward-looking information in accounting provisions. However, the new provisioning model makes accounting for credit loss provisions more complex and introduces an additional layer of management judgment as well as discretion in estimating the forward-looking ECL. This increased complexity and reliance on judgments will pose additional challenges in assessing objectively the provisioning approaches by external auditors but also by banking supervisors and accounting enforcers.

While the new impairment model is applicable to all entities, credit institutions and other entities providing financing to the economy are surely the most impacted by the introduction of the ECL model. Based on our initial assessment, only relatively few non-financial institutions are significantly impacted by the new model. On the other hand, the sector for which the application of the ECL model is very relevant is insurance. While smaller by total assets, the EU insurance sector represents roughly 1/3 of the banking sector (10 versus 30 trillion EUR in assets), it contributes significantly to the long-term financing of the economy and plays an important role in the proper functioning of the economic system. However, insurance undertakings – being individual groups or, in Europe, also those that are part of a financial conglomerate – have been granted the option

[1] Declaration on strengthening the financial system, London G20 Summit, 2 April 2009

to delay the application of IFRS 9 until 2021. This coincides with the effective date of IFRS 17, the new accounting standard for insurance contracts.

Having mentioned IFRS 17, and before I go straight to the core of today's topic, let me please take this opportunity to share with you three important messages on this new standard:

- Firstly, while we are still analysing its technical details, one thing that can already be affirmed with certainty is that IFRS 17 will improve comparability and transparency of financial information on insurance contracts when compared to the current situation. From this perspective, I would like to echo the 2017 statement of the Financial Stability Board[2] which welcomed this new standard.
- Secondly, I want to highlight the importance of making a timely shift towards a new accounting standard for insurance contracts. As we know, in the absence of a comprehensive accounting solution for insurance contracts in IFRS, an "interim" standard, IFRS 4, has remained in place for years. By permitting the continuation of different local accounting practices, IFRS 4 has resulted in a lack of comparability and transparency in the consolidated accounts of insurers and, as already mentioned, it has triggered a delay in the application of IFRS 9 for insurance undertakings. While some may have become accustomed to this state of things, we should keep in mind that investor protection and financial stability are at stake when we compromise on high-quality financial reporting. Therefore, while

[2] http://www.fsb.org/2017/07/fsb-welcomes-new-insurance-accounting-standard/

it is important to exercise caution in assessing the changes introduced by IFRS 17, I think it is necessary to avoid any further delays in reaching a common set of accounting standards for insurance contracts.

- Having said this, it should not come as a surprise to you that my third and last point on IFRS 17 is that we are quite concerned by the delay that we are observing in the endorsement process of IFRS 17 in the EU. While it is important that the insurance industry continues to have an open and constructive dialogue with the IASB to address any practical implementation issues, this should not put into question the core aspects of a model which was developed after more than 10 years of extensive research and consultation. Any delays in the endorsement process may: 1) Have severe impacts on the ongoing implementation efforts of issuers; 2) Make it more difficult for investors to start engaging in education activities and in the necessary interaction with issuers; and 3) undermine the credibility of the endorsement process itself.

Now that – I hope – I have made our position on IFRS 17 sufficiently clear, let me come back to provisioning in banks. While most banks have already spent several years preparing for the change to the new provisioning system, IFRS 9 only started to apply in practice from 1 January 2018. In many cases, implementation of IFRS 9 is still being fine-tuned. Keeping in mind the short period of time of the real-life application of the standard, some of the application and supervision challenges are still to be identified.

While auditors have been involved throughout the implementation process, in most cases, the use of the new models and implications for the financial reports will be, for the first time, fully scrutinised for the purposes of the statutory audit of the 2018 annual financial statements. Consequently, I would expect that over the next year, taking into account developing market practices, a number of changes to the implemented models will be introduced. It will be especially important for supervisors to understand not only the initial implementation but also closely monitor subsequent changes to ensure that IFRS 9 requirements are implemented in a proper and adequate manner.

ESMA will shortly publish its annual European Common Enforcement Priorities for 2018 year end, in which it focuses on some of the application issues of IFRS 9. It will focus in particular on the need for transparency and disclosures on assumptions of the ECL models and on the key judgements made. While some of ESMA's expectations are valid for all entities listed on regulated markets, a number of points relate specifically to the application of IFRS 9 in the banking sector.

A number of speakers have already discussed the standard's requirements and the implementation challenges of complex ECL models. In the remainder of my speech, I would like to address three specific points related to the ECL model:

1. Quantitative impact of IFRS 9;
2. Transparency and understandability of the ECL model by investors; and
3. Role of auditors and supervisory cooperation.

Let me address each of these topics.

Quantitative impact of IFRS 9

Based on the average reported quantitative impact in the financial statements, the introduction of IFRS 9 as of 1 January 2018 had, in most countries, a lower quantitative impact than originally expected. However, the widely reported headline figure of the impact on regulatory capital across the industry might not give the entire picture. The relatively modest impact needs to be assessed with caution, taking into account the existing differences between IFRS 9 and prudential requirements. Moreover, we should also take into account the improved economic situation and the related optimism, which likely have impacted economic forecasts. Let me now analyse these two potential drivers of this lower reported impact:

Relationship of accounting provisions and reported impact on capital

Firstly, the headline impact on regulatory capital, even when reported on fully loaded basis, might underestimate the true scale of the accounting impact, as it might be partly offset by the pre-existing shortfall of accounting provisions and expected losses calculated in accordance with the prudential requirements. On the other hand, considering the increase in the accounting provisions recorded in the financial statements, we noted diversity in the increase in provisions reported by individual banks across various loan types. In my view, this highlights the need for further efforts to achieve consistency and comparability of the outcomes of calculations from the ECL models. I acknowledge that the diversity in reported impact might be the result of inconsistencies in the way the incurred loss model under IAS 39 had been implemented. However, given the complexity of modelling and the role of judgment in determining some of the assumptions used in the ECL calculation, it cannot be excluded that new inconsistencies in the implementation of the provisioning are arising in practice.

Current economic conditions

Secondly, the calculation of the point-in-time ECL, used for accounting purposes, reflects the current economic conditions. These may prove to be too optimistic as they are based on the extrapolation of the benign economic outlook triggered by a prolonged period of accommodative monetary policy and low interest rates. In this respect, I would like to highlight the lessons learned from the financial crisis – the market having been blinded by a culture of “corporate myopia” and the assumption that short-term positive economic development will continue indefinitely. Caution is needed in the estimation of ECL. Multiple scenarios need to be reflected in the ECL modelling, given the non-linear nature of credit losses in response to a deteriorating economic outlook. In this context, I would like to highlight that the last report of the Joint Committee of the ESAs on risk and vulnerabilities in the EU financial system identifies repricing of risk premia and potential increase of interest rates as key factors that could negatively affect financial institutions. Hence, it is important that all relevant risks identified are reflected in ECL models.

This leads me to share with you an early observation that exemplifies this issue. In some countries, it seems that the effective expected lifetime (duration) of some contracts for which the lifetime ECL need to be calculated is relatively short. This might be the case for some long-term assets with prepayment options – such as mortgages. While issues with estimating the level of prepayment is not a new one, IFRS 9 increases the focus on this assumption due to the need to calculate the ECL over the lifetime of the exposure. The relatively short effective duration for lifetime ECL calculation is most probably due to taking into account the recent historical experience of prepayment rates. However, prepayment rates in the future might be very different from those in the past, given the current level of interest rates and stage of the credit cycle. Banks might also find out during the next downturn that the level of prepayment is more strongly correlated with credit risk. Hence, especially those loans with deteriorating credit quality might not have previously experienced prepayments levels. At that point, assumptions underpinning the ECL calculation might be revisited leading to a cumulative catch-up adjustment in the provisions which will be calculated for a longer estimated lifetime. In my view, such development would directly contradict the objective of IFRS 9 to reduce the cliff effect inherent in the incurred loss model. In order to address the issue, realistic scenario analysis and transparency on the assumptions made, play a key role in the proper application of the provisioning model.

Transparency

Let me now move to the next topic: the transparency and understandability of the ECL model and its impact on the financial statements for the users to whom financial reports are primarily addressed.

In this context, I welcome the initiative to publish separate detailed IFRS 9 transition reports by a number of banks, explaining the effect of the introduction of IFRS 9 on their financial position and performance. In many cases a greater level of transparency than explicitly required by the standard is necessary for investors to understand the effect of IFRS 9 introduction, notably as the comparative 2017 information will not be restated, but will be provided on the basis of IAS 39. It also seems that those banks that have published transition reports provide a broader set of information in their interim financial statements. However, I would like to reiterate that the separate transition reports cannot replace the required disclosure in the financial statements.

While ESMA has not undertaken a specific comprehensive study with regards to the interim financial statements that have already been published, there seems to be diversity with regards to the granularity of the information on the ECL models, and depth of the disclosures on the assumptions used and the judgements made. Some concerns have been raised with the detail and quality of the disclosures in the interim financial statements of some, notably smaller banks. This might indicate that data to be published are not yet available and the implementation process, especially in some of the smaller banks, may not be fully finalised raising questions on the reliability of the published figures.

I would like to further highlight the importance of disclosing material assumptions and judgements made in estimating ECL in order to enable users to understand the approach to the ECL calculation. Some of the key disclosures include the assessment of the significant increase in credit risk (SICR), incorporation of forward-looking information in the ECL model, and use of multiple scenarios for calculating the ECL.

Firstly, banks should disclose their approach to setting the criteria for identifying SICR for material portfolios. These disclosures should provide sufficient transparency on the qualitative and quantitative factors taken into account in the determination of SICR and provide transparency on the extent to which the SICR was assessed at portfolio level. The way such a portfolio approach is used should be disclosed and explained. This is an area where new practices are emerging and where the explanation of the approach could shed light on the robustness of the ECL implementation.

Secondly, banks should explain how they are taking into account forward-looking information in determining the ECL. This might be one of the more subjective parts of the ECL calculation, as market participants have inevitably different expectations of future developments, and use different forecast horizons. The financial statements should include sufficient information to enable users to assess the level of optimism of the economic forecasts and any deviations from the market consensus. This might also facilitate earlier recognition of losses thus fully benefitting from the IFRS 9 model that, unlike the previous accounting model, requires recognition of the ECL at an earlier stage. While we have seen quite informative disclosure on scenarios in some cases, most banks have only provided generic information.

Finally, let me also briefly mention the need to disclose the information on the multiple scenarios capturing the non-linear nature of the credit losses under the downturn scenario. While the impact on its own might not be material in all cases, I am of the view that it can often show additional insights on the risk appetite of the bank and its credit risk management.

In this context, I also believe that IFRS 9 can contribute to more sound credit risk management practices. A more in-depth analysis and better disclosure will further enhance the credit risk management practices. While the ECL model relies on judgment, which may make ensuring consistency in accounting more challenging, it also forces the banks to sharpen the credit risk management system and document the processes related to the credit risk assessment. Furthermore, disclosure of those judgments would help enhance transparency and help investors better understand the risk profile but also the risk appetite of the bank. These developments should in turn, help ensure proper implementation of IFRS 9 and thus contribute to a sounder and more stable financial system.

Role of auditors and supervisory cooperation

Before concluding, the last point which I would like to briefly mention is the scope of the involvement of auditors and supervisors in assessing the ECL model and the need for close cooperation between supervisors in assessing the implementation of IFRS 9. Already the 2017 report of the European Systemic Risk Board (ESRB) highlighted both these elements. The report also highlighted that the high-quality implementation of IFRS 9 and good cooperation between the various supervisors are pre-requisites for a positive effect of IFRS 9 on the broader economy.

It is generally accepted that the scope and depth of the verification of ECL model implementation by statutory auditors as well as banking and market regulators have a significant influence on the quality and consistency of the application of the new ECL model. While we welcome recent improvements in the relevant auditing standards, doubts remain whether the changes go far enough to improve the practice. In particular, we would have preferred the guidance to be more robust and specific to ensure consistent audit of judgements and estimates, given the complexity of modelling challenges inherent in the ECL model.

Supervisors have been preparing themselves for the assessment of the implementation of the new standard. However, supervisors need to step-up their efforts in capacity building and gain experience in assessing ECL models. The new ECL model poses particular challenges for both banking supervisors and accounting enforcers within their respective remits.

Accounting enforcers are developing their expertise to scrutinise more complex ECL models used in the financial statements. This requires additional resources for in-depth examinations. At the same time, banking supervisors, who have experience with reviewing prudential models need to build knowledge and gain experience on specific accounting aspects of the provisioning model. One of the ways for supervisors to prepare for the supervision of the ECL models efficiently, is to work more closely together. While there are already good examples of cooperation between supervisors, some barriers to this cooperation still exist. In my view, communication, cooperation, exchange of information as well as practical experience between accounting enforcers and banking supervisors need to be further reinforced to reflect the increased complexity of the ECL models. This is essential to ensure high quality, consistent implementation of IFRS 9.

Ladies and gentlemen, it is time to conclude.

I would like to underline that it is far too early for a definitive assessment of the overall impact of IFRS 9, both on financial statements and more broadly on security markets and the wider economy. This is because some of the effects can be observed only after a sufficient period of time has passed since initial implementation. The real evaluation of the ECL model will be possible only after the completion of a full economic cycle.

However, sound implementation and sufficient transparency on the assumptions are indispensable for the standard to operate as it was intended to. All actors need to work together and play their role: banks, auditors, supervisors: ensuring robust and consistent implementation of the new provisioning model as well as identification of any warning signs from its application.

Thank you for your attention.