ECONOMIC COMMENTARIES

IFRS 9 Implementation

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New accounting rules for recognising credit losses (IFRS 9) will be introduced in Norway from 2018. Under IFRS 9, recognition of credit impairment will be based on more forward-looking assessments than under the current rules. Banks' loan losses may increase, both when the rules are implemented and during down-turns, when credit risk rises. Many large Norwegian banks expect IFRS 9 to have little or no impact. The effects of the implementation of IFRS 9 have not yet been fully observed in practice, and therefore present policy challenges. As such, policy makers will continue to be challenged with dynamic considerations when addressing prudential systemic risk management.

1. Context

The global financial crisis exposed numerous vulnerabilities in the international financial system. As a result, many policy debates have ensued with the aim of improving the overall resilience of the financial sector. Such discussions have to a large extent focused on addressing the various shortcomings in prudential standards and supervisory oversight as noted by the G20.[2] One area of focus has been on appropriate standards governing the provisioning for credit losses. The recognition of and provisioning for credit losses under current standards has been criticised as unsound. Specifically, loan loss recognition has focused on past events instead of on future events. Under International Accounting Standard (IAS) 39, provisions for loan loss recognition have been largely based upon objective evidence of a loss event according to *incurred loss* models. The backward looking nature of such accounting standards contributed to loan losses that have been broadly referred to as "too little, too late". To address this issue, International Accounting Standards Board (IASB) published International Financial Reporting Standard (IFRS) 9 in July 2014 with implementation from January 2018.[3] IFRS 9 requires loan loss provisioning to be taken based upon future losses according to *expected credit loss* models.[4]

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[1] The views and conclusions of this publication are the author's own and are not necessarily shared by Norges Bank. Therefore, they must not be reported as Norges Bank's views. I thank Henrik Andersen, Arild Lund, Kjell Bjørn Nordal, Elise Vik Sætre, Ylva Søvik and Sindre Weme for comments. The author is responsible for any remaining errors and omissions.

[2] See statements from G20 (2009)

[3] Full document of IFRS 9

[4] While IFRS are largely followed outside the U.S. including in Norway, the Financial Accounting Standards Board (FASB) issued a similar standard focused on expected credit losses in loan loss provisioning for U.S. Generally Accepted Accounting Principles (GAAP) in 2016 to be implemented by 2021.

2. Background

Loan loss reserves[5] represent a contra-asset line item on the balance sheet that is intended to absorb against current losses. This differs from capital which represents an equity line item on the balance sheet that is intended to absorb against future unexpected losses. Loan loss reserves are developed over time through the accumulation of loan loss provisions, an expense item on the income statement that recognises current losses on loans. Under IAS 39, loan loss provisions have been largely reported on an ex-post basis.[6] Specifically, provisions are taken after a "loss event" has occurred based upon incurred-loss models. Since incurred-loss models focus on objective evidence of loss, they can limit the potential for earnings management through discretionary loan loss provisioning, as noted by Gebhardt and Novotny-Farkas (2011). There has been extensive research on the potential for capital and earnings management through discretionary loan loss provisioning.[7] Market participants often seeking transparency in financial statements may have appreciated such methodical approaches before the crisis. However, as Dugan (2009) noted, provisioning based upon incurred loss models in practice reinforced the procyclicality effects that were observed during the financial crisis. Several analyses have supported the concept that delays in loan loss provisioning under incurred loss models have contributed to procyclicality.[8] In addition, the employment of such models in practice can lead to incomparable results due to the potential for varying underlying assumptions and inconsistency in application, which can inhibit transparency.

Under IFRS 9, loan loss provisioning will largely be reported on an ex-ante basis. Specifically, provisions will be taken before the loss event has occurred, based upon forward-looking information calculated through expected credit loss models. The new standards represent a shift in focus toward more prudential considerations in the practice of provisioning for loan losses. Provisioning will no longer focus on past one-off events, but rather what could likely happen over the life of the financial asset. Against the backdrop of a financial cycle, such an approach may reduce procyclicality. However, the results have not yet been observed in practice.[9]

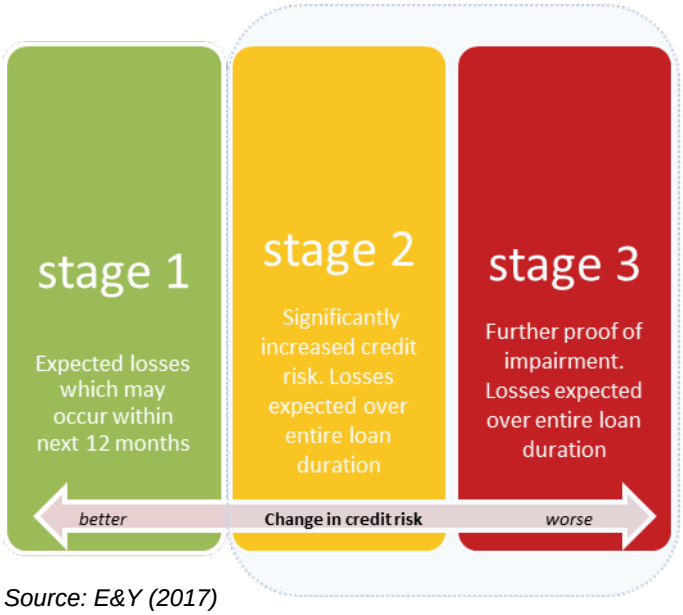
[5] Loan loss reserves are also referred to as the Allowance for Loan and Lease Losses (ALLL) in the U.S. or loan loss allowances in general.
[6] Informational copy of IAS 39 from the European Commission
[7] See for example, Moyer (1990), Beatty et al. (1995), Collins et al. (1995), Liu and Ryan (2006), and Norden and Stoian (2013).
[8] See for example, Laeven and Majnoni (2003), Beatty and Liao (2011) and Bushman and Williams (2015).
[9] See further discussion below under "Procyclicality".

3. IFRS 9

Under the new rules, provisions against loan losses will focus more on the consideration of forward-looking information. IFRS 9 requires that the measurement of expected credit losses shall be based on an objective and probability-weighted analysis of alternative outcomes including consideration of the present value of expected future cash flows generated from the financial asset.[10] There are three stages of loan loss provisioning under IFRS 9 as noted in Figure 1. Under IFRS 9, initial, Stage 1, recognition requires loan loss provisions be taken that consider credit risk over a 12-month period from the reporting date.

If there is a significant increase in credit risk, a Stage 2 or Stage 3 recognition must occur, which requires consideration of expected credit losses over the lifetime of the loan.[11] IFRS 9 notes that institutions must consider forward-looking information and not solely rely on past-due data for considering a significant increase in credit risk. However, it also noted that regardless of other considerations, a significant increase in credit risk has occurred in principle when contractual payments are 30 days past due. Classification to Stage 3 from Stage 2 requires additional objective evidence of impairment, such as the occurrence of a loss event.

Figure 1: IFRS 9 Loan Loss Provisioning



Source: E&Y (2017)

[10] IFRS 9 generally applies to financial assets held at amortised cost and held at fair value through other comprehensive income.
[11] Under FASB's similar standard for expected credit loss provisioning, all expected credit losses are considered over the lifetime of the loan from the time the asset is recorded on the balance sheet, likely resulting in higher overall provisioning levels, and therefore is more conservative in principle relative to IFRS 9.

While Stages 2 and 3 are similar in terms of a lifetime expected loss consideration and provisioning, Stages 1 and 2 are similar in their calculation of interest revenue. Stages 1 and 2 require the interest revenue to be calculated on the gross carrying amount of the loan, without deducting for provisions. Stage 3 requires the interest revenue to be calculated on the net carrying amount of the loan, or the amount of the loan after deducting for lifetime expected credit loss provisions.[12] As such, moving loans from a Stage 2 to a Stage 3 expected credit loss may pressure reported interest income on the margin. Under IAS 39, interest revenue calculations are generally completed after the deduction of impairments.[13]

4. Impact

As provisions will now be primarily assessed on an ex-ante, rather than ex-post, basis, there has been discussion about the impact on bank performance and balance sheets. Specifically, there has been general concern that these accounting practices may increase loan loss provisioning, both upon implementation of the standards as well as during contractions in the business cycle, potentially reducing profitability and eroding regulatory capital ratios. The European Banking Authority (EBA) has undertaken survey-based assessments evaluating the impact of IFRS 9 on bank balance sheets. Results of the first EBA exercise associated with this effort were published in November 2016 and estimated provision levels to increase by an average of 18% as a one-time effect upon implementation of the new standards, compared to current levels.[14]

The EBA's second exercise, published in July 2017, broadened the scope of the first exercise and considered advancements in related processes and models.[15] Results from the second exercise estimated provision levels to increase by an average of 13%. The second exercise also estimated that IFRS 9 would on average decrease Common Equity Tier 1 ratios by 0.45 percentage points and total capital ratios by 0.35 percentage points. The Basel Committee on Banking Supervision and the European Commission both support a transitional period for the new standards, which may ease the impact on capital levels.[16]

In the EBA's exercises, it was noted that consideration under Stage 2 expected credit losses was the largest driver of heighted loan loss provisions. In addition, several banks noted that there was a 'cliff effect' in the transition from Stage 1, 12-month expected credit loss, to Stage 2,

[12] See E&Y (2017)
[13] Expected credit loss provisioning under FASB's standard retains current rules – cash basis method and/or cost recovery method – for interest revenue recognition on a "financial asset with a credit loss" (formerly, "impaired loan") that limit the accrual of interest income and therefore can be considered as more conservative.
[14] See EBA (2016)
[15] See EBA (2017)
[16] See BCBS (2017) and EC (2017)

lifetime expected credit loss, which could result in heightened earnings volatility. However, some of the institutions indicated that they did not expect heighted volatility in earnings resulting from the implementation of the standards. It was noted that despite uncertainty around the final impact of IFRS 9, banks have made significant progress in assessing expected implementation impact.

In terms of its impact on Norwegian banks, several of the large banks indicated that the impact would be limited or non-existent.[17] In its 2016 annual report, DNB Bank indicated that it was too early to give a reliable estimate of the impact, but expectations indicated higher loan loss provisioning.[18] Nordea Eiendomskreditt AS noted in its 2016 annual report that it expected higher provisioning and lower equity as a result of the implementation of IFRS 9, but noted that it did not expect material impact on large exposures.[19]

5. Procyclicality

While ex-ante provisioning is intended to reduce procyclical effects, increased loan loss provisions during business cycle contractions may result in larger and more procyclical fluctuations in bank lending and economic activity. However, the evidence to date has been mixed and was recently highlighted in a report by the European Systemic Risk Board (ESRB) (2017). In terms of reducing procyclicality effects, it was noted that if losses could be identified and addressed more quickly, it may boost market confidence through structural improvements related to transparency and discipline. This is consistent with an analysis by Bushman and Williams (2012) that discussed the potential market discipline benefits associated with forward-looking loan loss recognition. Beatty and Liao (2011) also noted that delays in loan loss recognition were associated with greater reductions in lending during economic contractions. As such, IFRS 9 could in effect serve to reduce procyclicality and therefore improve financial stability on the margin.

On the contrary, the ESRB also noted that procyclicality effects could increase if loan loss provisions increase rapidly due to changes in expected credit loss expectations in the context of a quickly deteriorating economic situation. This was supported in a model-based analysis by Abad and Suarez (2017), where a corporate European loan portfolio experienced a concentrated impact on profitability and capital coverage upon a contraction in the business cycle. In addition, capital requirements coupled with potentially higher loan loss provisioning under expected credit loss models may lead banks to reduce lending in order to maintain capital coverage in business cycle contractions. Mésonnier and Monks (2015) and Gropp et al. (2016) completed related

[17] Kommunalbanken, SR-Bank, Sparebank1 Hedmark, Sparebank1 Nord-Norge, Sparebank1 SMN and Sparebanken Sør.
[18] DNB Bank 2016 Annual Report
[19] Nordea Eiendomskreditt 2016 Annual Report

studies showing that banks have improved capital coverage ratios by largely reducing customer loans. As such, higher loan losses in the context of regulatory capital requirements may result in procyclical effects on the economy. However, the impact of this could be somewhat mitigated through the prudent implementation of countercyclical capital buffers.

6. Policy Considerations

The effects of the implementation of IFRS 9 have not yet been fully observed in practice, and therefore present policy challenges. In terms of addressing potential policy issues, the ESRB (2017) noted the following areas as warranting consideration: 1) consistent and transparent disclosure standards; 2) effective use of existing capital buffer tools; 3) stress testing exercises; and, 4) additional prudential adjustments. The continuous analysis of macroeconomic considerations and tailoring of macroprudential tools, as well as consistent disclosure standards will be central to effective prudential systemic risk management.

The report also noted that the implementation of IFRS 9 could change credit portfolio compositions and impact capital calculation approaches employed under Basel standards. These challenges also warrant active policy management to address systemic changes. Further, it was noted that “modelling risk” remains a policy challenge. While the focus on improved prudence and transparency are central to the aims of IFRS 9, potential variations in the interpretation of standards and implementation of related models can lead to inconsistent disclosure and may inhibit prudential policy objectives. These challenges must also be addressed, for example through effective audit activities, also noted by the ESRB. Prudential procyclicality management requires the proactive monitoring of and response to emerging and changing risks, some of which may have not yet been fully appreciated. Finally and in principle, differences between IFRS 9 and related FASB standards should be minimised in order to reduce inconsistencies. This should increase transparency and improve market confidence. As such and considered together, policy makers will continue to be challenged with dynamic considerations when addressing prudential systemic risk management.

7. Concluding Remarks

IFRS 9 represents a significant change in the approach which banks use to measure and report loan loss provisions. It sets out broad principles that vary considerably from those under IAS 39, with a focus on provisioning for expected credit losses, instead of incurred losses. As such, models to calculate provisioning requirements will change notably. Institutions retain a large degree of discretion in the modelling of expected credit losses. This may potentially inhibit transparency-related efforts inherent in IFRS 9 objectives. While these changes represent potential shifts toward more prudential standards, and can improve transparency in theory, the implementation of these new accounting standards presents challenges that should be managed by policy makers. Measures that ensure consistency in the development and employment of models in order to minimise potential differences in reported financial statements will remain crucial to enhancing disclosure in practice. This is central to improving transparency and potentially realising the benefits of reduced procyclicality.

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