

The First ‘Real’ Test of IFRS 9 The Economic Fallout from the COVID-19 Pandemic

In the run up to and including the period of the Global Financial Crisis, the accounting standard for the recognition and measurement of financial instruments, IAS 39¹, governed the impairment provisioning methodologies used by banks in Ireland. IAS 39 required objective evidence of impairment and that a loss had been incurred before impairment provisions could be made. The standard did not permit the recognition of expected losses even where such losses were highly likely.

The financial statements of one Irish bank published in the summer of 2008 showed modest loan loss provisions. In compliance with IAS 39, its loan loss provisions were relatively low despite all that was then known about the likely level of loan losses. Months later, the same bank had little option but to request a government bailout of several billion euro. One year later, its financial statements showed that its loan loss provisions were more than 16 times those of the immediately preceding year.

IAS 39 effectively permitted the deferral of the recognition of credit losses on loans until customers were actually at or on the threshold of default, in effect, only when customers actually missed payments. This weakness in IAS 39 was the catalyst for the creation of a new accounting standard IFRS 9 Financial Instruments (“IFRS 9”) which requires banks to make loan loss provisions when there is a ‘*material change in circumstances*’. IFRS 9 became effective for annual periods beginning on or after 1 January 2018.

IFRS 9 takes a different approach to loan loss provisioning than its predecessor, IAS 39. IFRS 9 requires an “*expected credit loss*” model that focuses on the risk that a loan will default rather than whether a loss has been incurred. In effect, IFRS 9 requires banks to recognise anticipated credit losses up front.

Not surprisingly then, the combination of the COVID-19 pandemic and the operation of IFRS 9 has led to banks reporting higher loan loss provisions. The ‘*expected credit loss*’ models of IFRS 9 have a macroeconomic component embedded in them, so with unemployment expected to rise and remain high for a period of time and GDP expected to contract, even if a bank expects to have no defaults, it is likely to report higher loan loss provisions. In requiring banks to make earlier provisions for loan losses, IFRS 9 allows the shareholders of banks to see losses earlier rather than be suddenly surprised by the extent of loan losses as was the case under IAS 39.

IFRS 9 requires banks to take earlier provisions for loans going bad, especially when they cross key thresholds such as a “*material change in circumstances*”. This forces banks to take provisions for loan losses over the entire lifetime of a loan.

1 Financial Instruments: Recognition and Measurement

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Even if a borrower does not default on a loan, the behavioural pattern of that loan in a bank's portfolio, in terms of going through periods of increased credit risk, is what impacts a bank's profits under IFRS accounting.

IFRS 9 introduces a 3-stage model for loan impairments:

- Stage 1: The initial recognition of the credit risk of the loan at the moment of origination which gives rise to a loan loss provision designed to reflect the risk of default within the next 12 months. The loan loss provision should generally align with the risk pricing built into the interest rate.
 - Provided the loan stays in the Stage 1 category, every twelve months, its credit risk is evaluated again and, if necessary, a further provision against additional losses likely to arise in the next twelve months will be made.
- Stage 2: The credit risk of the loan has increased significantly since initial recognition and is no longer considered to be low. Expected credit losses on the loan resulting from all possible default events, weighted by their probability of occurrence, over the life of the loan must now be recognised under IFRS 9.
- Stage 3: Non performing

The loan loss provisions and changes in the loan loss provisions arising under the three Stages above are recognised as impairment gains and losses in the income statements of banks.

The movement of a credit facility from Stage 1 to Stage 2 requires significantly higher loan loss provisions. The loan loss provision in Stage 2 is the expected credit loss over the expected lifetime of the loan. Where the borrower has posted collateral as security for the loan, the increase in loan loss provision in moving from Stage 1 to Stage 2 will be mitigated through a lower 'loss given default' figure.

Absent collateral or a guarantee, the longer the duration of a loan the higher the increase in the loan loss provision as a loan moves from Stage 1 to Stage 2. While it is difficult to generalise as to the magnitude of Stage 2 expected credit losses, which are lifetime expected credit losses, compared with Stage 1 provisions, Stage 2 provisions may be up to 15 to 20 times those of Stage 1 provisions. Thus, with the economic fallout from the COVID-19 pandemic, IFRS 9 has the potential to lead to excessive provisions for impaired loans which in turn would reduce a bank's 'own funds' and thereby decrease its Common Equity Tier 1 ("CET1") capital.

Indeed, the European Commission recently published an "interpretative communication" to ensure banks do not apply existing accounting and capital rules too conservatively. This feature of IFRS 9 strengthens the system and allows shareholders to see rising losses earlier rather than later all at once. The current excess provision reserves many banks hold today are thanks to IFRS 9.

At the level of an individual credit facility, a breach of a loan covenant by a borrower for a period may move a credit facility from Stage 1 to Stage 2 with consequent implications for impairment charges in the income statement; in time, the breach may be remedied and the loan may move back to Stage 1.

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Expected credit loss models also have a macroeconomic component embedded in them. An economic downturn, like that caused by the COVID-19 pandemic, could trigger the movement of a significant block of credit facilities from Stage 1 to Stage 2 causing significant impairment charges to hit the income statements of banks. This feature of IFRS 9 certainly alerts shareholders to the potential for rising losses and increases the bank's provisions against such potential losses. However, there is a question as to whether any models, trained on previous economic crises, can properly cater for this unique COVID-19 crisis, with its unprecedented sharp shock and a corresponding government set of responses and supports.

COVID-19 Pandemic Crisis and IFRS 9

Compared with the Global Financial Crisis in late 2008, banks, in general, were better capitalised coming into the COVID-19 pandemic crisis. The COVID-19 pandemic crisis has had a disproportionate effect on some sectors of the economy; compare the need for technology and telecoms with more people working from home with the complete lockdown of the leisure sector, bars, accommodation outlets, restaurants, and gyms. Banks with unsecured lending to companies and employees in the leisure sector are likely to have to set aside significant loan loss provisions under IFRS 9.

IFRS 9 was not applicable during the Global Financial Crisis which was characterised by a largely property-related lending bubble followed by a significant deterioration in the value of assets including assets held by banks as collateral.

As the demand for emergency lines of credit rises across the various stages of the lifting of lockdown, in the absence of government guarantees for all or part of such loans, banks are likely to underwrite such applications very carefully so as to avoid clients and sectors that are 'risky' from the perspective of IFRS 9. Banks naturally try to minimise credit risk and try to avoid lending to customers that are highly likely to default. Banks may also be reluctant to commit to longer loan terms because of the higher provisioning impact that a long duration loan has relative to a short duration loan of the same outstanding amount when such loans move from Stage 1 to Stage 2.

IFRS 9 – Impact on Bank Profits and the Volatility of Bank Profits

In view of the cost of financing the regulatory capital required to fund Stage 2 migration of loans, IFRS 9 has effectively reduced bank profitability. The banks suffering the biggest impact on profit margins are likely to be: (i) those granting medium-term or long-term loans to clients exhibiting relatively poor credit metrics and who don't post collateral or provide a guarantee; and (ii) those not charging appropriately for the combination of probability and cost of financing a migration to Stage 2.

Through the three-stage model for impairments, IFRS 9 introduces volatility into the income statements of banks. While each credit facility granted remains on the books of a bank, its behaviour has the potential to add to the volatility of the bank's income statement should it oscillate through the first two stages even if it were never to become a non-performing loan. Highly proactive credit risk management was perhaps never more important for banks as such strategies can

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prevent credit deterioration and reduce the number of credit facilities migrating from Stage 1 to Stage 2.

After the COVID-19 Pandemic

Unless constrained by competition, the cost of longer-term, poorly collateralised loans for higher-risk clients and those in certain sectors of the economy is likely to rise. Banks may also set a limit on their exposure to such clients in view of the increased risk of migration from Stage 1 to Stage 2. The cost to banks of a migration of such loans to Stage 2 as a result of, for example, a breach of a balance-sheet ratio or liquidity covenant, is likely to be factored into the initial pricing of the loan or through an increase in the interest rate charged on the loan once a covenant is breached. Such increases in the interest rate would vary by the expected time that the loan would spend in Stage 2 and the remaining term of the loan at entry to Stage 2.

Faced with the impact of IFRS 9 on profitability and on the volatility of profitability, banks may wish to take advantage of the growth in demand for investment in private lending. A bank could avoid the impact of such risky loans on its risk-weighted assets and CET1 ratio by originating such loans, transferring them to a special purpose vehicle, and distributing them to institutional investors unrelated to the bank which have an appetite for such investments and their associated risks. In this way, a bank can collect an origination fee and avoid the substantial increase in provisions it would otherwise have to make if the loan migrated from Stage 1 to Stage 2.

Conclusion

The economic fallout from the COVID-19 pandemic is probably the first real and significant test of the impact of IFRS 9 on the financial statements of banks.

The economic downturn arising from the COVID-19 pandemic will lead to higher IFRS 9 loan loss provisions. While central banks have announced regulatory capital reliefs for banks to deal with the impact of the COVID-19-pandemic-induced economic downturn on banks' regulatory capital, the question is: Will much of this capital relief be absorbed by the higher IFRS loan-loss provisions? If the answer is yes, then there may not be enough regulatory capital remaining to provide emergency lines of credit to companies absent governments guaranteeing a significant portion of such loans.

Further, as the results of the 'first real test' of IFRS 9 emerge, banks may limit lending or charge more for loans to risky clients in certain sectors of the economy seeking long-term loans which are not supported by collateral or guarantees. The COVID-19 pandemic has shown a coincidence in the timing of IFRS 9 loan-loss provisions and a demand for emergency lending by businesses and individuals, both of which reduce banks' CET1 ratios by reducing 'own funds' and increasing risk-weighted assets respectively. The coincidence in timing may lead to fresh rounds of equity raising by banks, perhaps further diminishing the profitability of banks.

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