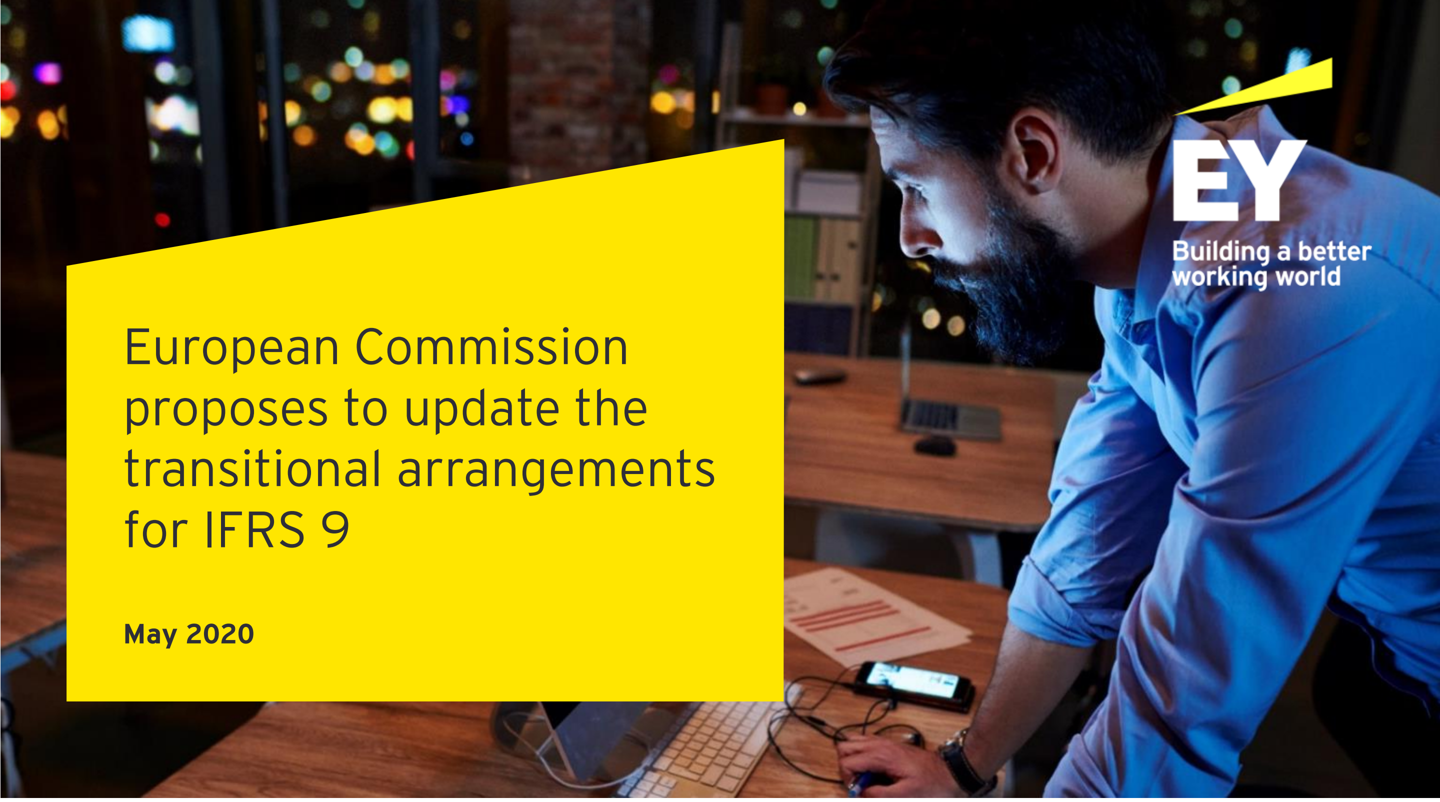

European Commission proposes to update the transitional arrangements for IFRS 9

May 2020

On 28 April 2020, the European Commission (EC) published a proposal[1] that included an amendment to the Capital Requirements Regulation (CRR) to mitigate the impact of COVID-19 on credit institutions' capital. The change is a "reset" of the transitional arrangements, providing a mechanism designed to simply and effectively alleviate concentrated pressure on capital from COVID-19.

This is especially pertinent for institutions with significant portfolios, subject to the standardised approach (SA), as under the internal ratings based (IRB) approach, relief is only allowed when the IFRS 9 expected credit loss (ECL) exceeds regulatory expected loss (reg-EL).

Background

- The transitional arrangements were implemented in CRR Article 473a, comprising two elements to add back over the following five years:
- A "static" amount, with the Day 1 International Financial Reporting Standards (IFRS) 9 provision stock compared to the IAS 39 provision stock.
- A recalculated "dynamic" amount comparing stage 1 and stage 2 provisions at the year-end reporting date with stage 1 and stage 2 provisions on day 1.
- This was subject to a decreasing factor: year one, 95%; year two, 85%; year three, 70%; year four, 50%; year five, 25%.
- The calculation differed for exposures under the IRB approach versus those under the SA, to ensure that reg-EL was considered for relevant IRB portfolios. This means that relief is only allowed when the IFRS 9 ECL exceeds reg-EL – otherwise it is floored at zero.

Why is it being amended?

- The EC notes it is to direct capital where it is needed most, balanced with a prudent mindset. The drive to ensure liquidity for the real economy and for consumers is clear.
- The application[2] of the transitional arrangements in 2018 was distorted across the European Union – it was notably applied in Cyprus, Greece, Italy and the United Kingdom. From data submitted in Q2'18, the European Banking Authority (EBA) noted that "the CET1 impact resulting from the add-back of provisions for all the banks in the sample corresponds to 118 (basis point (bps)) on simple average (48 bps on weighted average)."
- In its communication[3], the EC states that "Banks are encouraged to implement [the transitional arrangements to] reduce the impact of IFRS 9 ECL provisioning on banks' regulatory capital". The ECB also noted[4] it expects all banks under its supervision to fully implement the transitional arrangements.

1 What is proposed?

- The dynamic element is revised. From 2020, the increase in new stage 1 and stage 2 provisions will be added back to CET 1 capital, on a wind down basis.
- The new Day 1 reference date for the dynamic element is 1 January 2020 for all IFRS 9 institutions.
- The dynamic wind down percentage factor is also reset being 100% in year one and year two, 75% in year three, 50% in year four and 25% in year five.
- The static component of the calculation remains as per the original Article 473a text and timelines.
- If an institution did not previously elect to use the transitional arrangements, it can now request approval from its competent authority.
- Institutions must disclose the adjusted and unadjusted capital and related ratios, via Pillar 3 disclosures.

2 Why does this matter for credit institutions?

- For portfolios on the SA method, without the transitional arrangements the increased ECL will directly flow into CET1 due to the loss recorded in retained earnings.
- For portfolios on the IRB method, the check to reg-EL will mean the impact may not be immediate – reg-EL is a more conservative calculation, whilst ECL requires objective judgement. Reg-EL is also generally based on a twelve-month period, whereas IFRS 9 reflects the lower of twelve months or residual maturity.
- However, as IRB models are often "through-the-cycle" models, there is a cyclicality not in sync with IFRS 9 models that utilise a 'Point-in-Time' method with a forward-looking view. This means that the deficit of EL is likely to grow in a continued downturn and an add-back may be permissible.

3 How would it work?

For SA portfolios with the transitional arrangements already applied, a simplistic view of the proposal is as follows:

CET1 capital as at 31 Dec 2017	50,300
Total IAS 39 provision as at 31 Dec 2017	1,000
Total IFRS 9 provision as at Day 1, 1 Jan 2018	1,300
Impact from adoption of ECL model on Day 1	300
IFRS 9 Stage 1 and Stage 2 provisions as at Day 1, 1 Jan 2018	320
IFRS 9 Stage 1 and Stage 2 provisions as at 1 Jan 2020	400

Key

New COVID-19 data

Reporting date	$A2_{,SA}$	$A2_{,SA}$ Factor	$A2_{,SA}$ Add back	Stock of ECL provisions at reporting date	*of which* Stage 1 or Stage 2	$A4_{,SA}$ *Max of value or nil*	$A4_{,SA}$ Factor	$A4_{,SA}$ Add back	Transitional amount (TA)	Fully loaded CET1 capital[1]	CET1 capital after TA
31 Dec 2018	300	95%	285	1,400	350	30	95%	29	314	49,900	50,214
31 Dec 2019	300	85%	255	1,500	400	80	85%	68	323	49,800	50,123
31 Dec 2020	300	70%	210	4,000	1600	1,200	100%	1,200	1,410	47,300	48,710
31 Dec 2021	300	50%	150	3,500	1400	1,000	100%	1,000	1,150	47,800	48,950
31 Dec 2022	300	25%	75	3,200	1200	800	75%	600	675	48,100	48,775
31 Dec 2023	300	0%	-	3,000	1000	600	50%	300	300	48,300	48,600
31 Dec 2024	300	0%	-	2,800	800	400	25%	100	100	48,500	48,600

4 What are the timelines?

The proposal is subject to the regular decision-making process, with the endorsement of the European Parliament and Council required. No timelines have been committed to currently; however the publication stresses the urgency of adoption.

References

[1] "Documents," European Commission website, https://ec.europa.eu/finance/docs/law/200428-banking-package-proposal_en.pdf, April 2020, accessed 29 April 2020.

[2] "Documents," European Banking Authority website, https://eba.europa.eu/sites/default/documents/files/documents/10180/2087449/bb4d7ed3-58de-4f66-861e 45024201b8e6/Report%20on%20IFRS%209%20impact%20and%20implementation.pdf?retry=1, 20 December 2018, accessed 29 April 2020.

[3] "Documents," European Commission website, https://ec.europa.eu/finance/docs/law/200428-banking-package-communication_en.pdf, April 2020, accessed 29 April 2020.

[4] "Press releases," European Central Bank website, https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs~a4ac38e3ef.en.html, April 2020, accessed 29 April 2020.

The EY view

The transitional arrangements remain a useful, straight-forward mechanism to alleviate significant impact on capital and avert any breach of minimum capital requirements as a result of IFRS 9.

The impact can be seen for institutions that opted-in on day 1. In a sample of six which published first quarter results in 2020, the transitional arrangements provide a benefit of 20 bps. As these reporters have both IRB and SA portfolios, the benefit for institutions with only SA portfolios will be larger.

In this period of volatility, with unpredictable forecast projections, the transitional arrangements may provide "breathing space" when most needed.

EY tools and thought leadership

EY Spotlight is a quantitative analytics tool that provides real-time updates on the status of COVID-19 globally, macro-economic impacts and regulatory updates. The EY Spotlight tool also has the capability to simulate the impact of COVID-19 on loan losses, taking into account deterioration of credit quality and relief measures.

EY teams have recently issued a series of publications to assist clients in understanding the impact on the accounting practices due to the COVID-19 pandemic.

- IFRS Developments (March 2020) – IASB and regulators highlight IFRS 9 ECL requirements during the COVID-19 pandemic.
- Applying IFRS Accounting Considerations of the coronavirus outbreak (April 2020).
- IFRS 9 response to COVID-19: Maintaining robust and controlled expected credit losses during the COVID-19 crisis.

How EY can help

EY teams can assist you in understanding the rules and determining the application for your firm, including the long-term considerations. EY teams also have a number of tools to demonstrate the impact, assisting visualisation and secondary effects. To discuss how this applies to your firm, contact your local EY team or the EY contacts below. EY's approach uses the following framework:

Now

Next and beyond

- Understand the rules
- Design the calculation
- Test and implement
- Report for period ends
- Integrate into IFRS 9 strategy
- Monitor ongoing impact

Your EY team

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