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The Adoption Of IFRS 9 And Bank Ratings

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The year 2018 brings sweeping new rule changes for the way banks reporting under IFRS estimate credit (loan) losses in their financial reporting. The new rules are set out in International Financial Reporting Standards 9, "Financial Instruments." One of its key aims is to address the issue of delayed recognition of credit losses in financial reporting, which came to the forefront during the financial crisis. That is why IFRS 9 shifts the accounting of credit losses to a more forward-looking "expected credit loss" impairment model that will require earlier recognition of credit losses in banks' financial reporting compared to the previous (IAS 39) "incurred loss" approach.

IFRS 9 will affect banks across much of the world--outside of the U.S. and Japan. In the U.S., new rules on accounting for credit losses, which differ from IFRS 9, do not take effect until 2020 at the earliest. In Japan, most banks will continue to report under Japanese GAAP (which incorporates an element of expected credit losses) or U.S. GAAP.

Overview

- Banks reporting under IFRS are now required to apply a more forward-looking approach to provisioning for credit losses under IFRS 9, which is likely to increase such provisions on initial adoption and greater volatility thereafter.
- The higher credit-loss provisions will be reflected immediately in full in our capital measures for 2018, but we don't expect widespread changes to issuer credit ratings on initial adoption, given that it is change in reporting--not a change in underlying economic activity.
- Provisioning is set to vary more greatly from bank to bank, increasing complexity and lessening comparability, which is a big disadvantage for investors, not least because of the diverging IFRS and U.S. GAAP approaches.
- The potential risks that IFRS 9's earlier and higher provisioning requirements could amplify the swings of the economic cycle are not yet clear. Full and consistent application of the rules, which may require regulatory encouragement and monitoring, will lessen such pro-cyclicality risks.

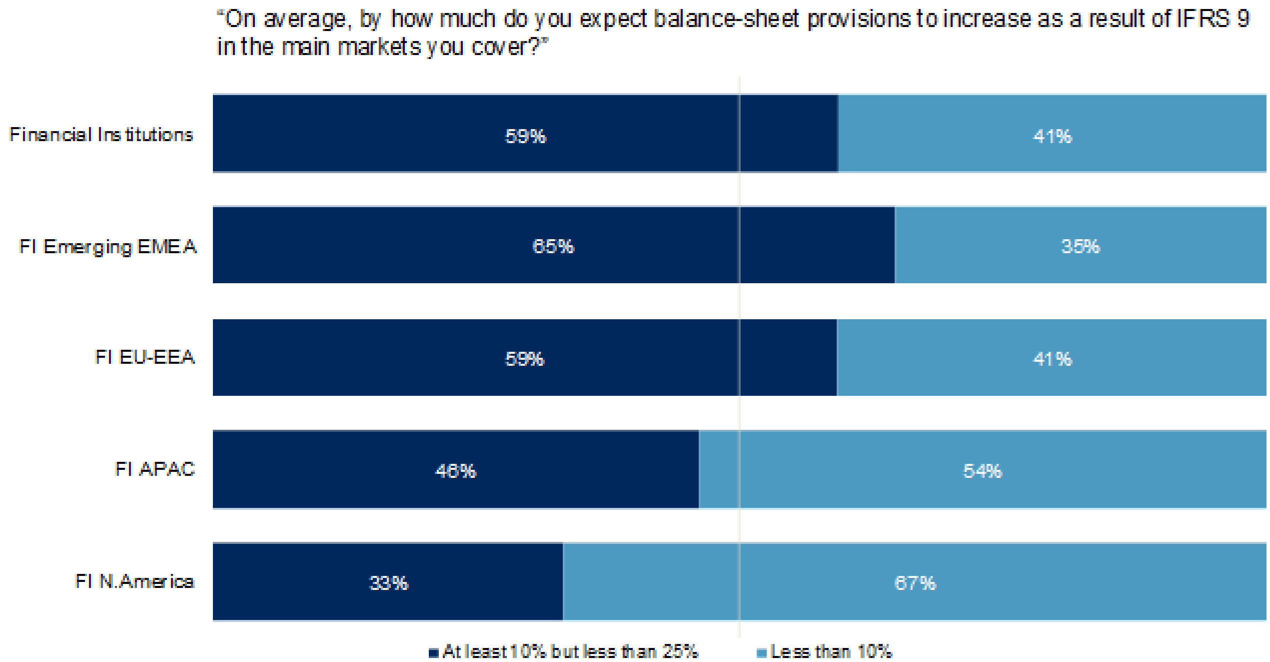
In addition to the reform of accounting for credit losses, IFRS 9 also serves as a single accounting standard that includes finalized requirements for the classification and measurement of financial instruments, and general hedge accounting. The new rules will drive some one-off gains or losses from the revision in classification and measurement rules, but we do not expect them to be material for the vast majority of banks. We also do not expect banks' hedge accounting approaches to change materially, because IFRS 9 doesn't include any changes for macro hedging (including hedging interest rate risk in the banking book).

IFRS 9 came into force for accounting periods beginning on or after Jan. 1, 2018, so for a large majority of banks reporting under IFRS, the first annual accounts that incorporate the new rules will be the accounts for the year ended Dec. 31, 2018. Where banks have a different year-end date (say, March 31), their first annual accounts incorporating IFRS 9 will be March 31, 2019, unless they choose to adopt the requirements earlier or are required to do so by local regulation. In addition, in some jurisdictions the implementation date has been deferred or not yet finalized.

In our recent global financial institutions analyst survey (see "Global Financial Institutions Analyst Survey 2018" published on Feb. 13, 2018), the majority of our financial institutions analysts (59%) expect IFRS 9 will increase provisioning by between 10% and 25%, while the remainder (41%) expect an increase of less than 10% (see figure 1) .

Figure 1

IFRS 9 And Expectations Of Our Credit Analysts



Results based on 60 responses. Latin America excluded due to limited responses to this question. Source: S&P Global Ratings' Financial Services Analyst Survey 2018.

How We'll Reflect The Higher Provisions In Our Capital Metrics

IFRS 9's higher credit loss provisions will generally lead to a reduction in our risk-adjusted capital (RAC) ratio, mostly through the numerator of the ratio (total adjusted capital or TAC). TAC takes as its starting point reported common shareholders' equity. All else being equal, the increase in provisions, which we will factor into TAC in full, will mean a lower level of TAC and lower RAC ratios. Regulators may allow banks transitional relief with respect to IFRS 9, for example by adding back a portion of incremental provisions into regulatory capital measures such as common equity tier 1 (CET1). Contrary to regulators, we will consider the "fully loaded" impact of IFRS 9 in our 2018 year-end RAC ratios. While calculated RAC ratios for 2017 year-ends will be unaffected (as IFRS 9 will be implemented through a change to 2018 opening balance sheets), our projected RAC analysis will factor in the quantitative information about IFRS 9 effects that banks are now finally starting to disclose.

In addition, in some jurisdictions, increased provisions will also likely lead to the recognition of additional deferred tax assets (DTAs) on the balance sheet, due to the temporary differences between the recognition of the new provisions for accounting purposes and the ability to expense such provisions for tax purposes. We usually cap DTAs arising from timing differences at 10% of "intermediate adjusted common equity"--that is, 10% of TAC before considering DTAs from timing differences and eligible hybrid capital instruments. There are some exceptions in jurisdictions (such as Italy, Spain, and Brazil) where some DTAs are readily convertible into claims against the government that can be settled in the form of liquid assets (such as government bonds) without delay at the time the bank incurs a loss. It is not yet fully clear the extent to which DTAs arising from IFRS 9 provisions will qualify for such treatment in the affected jurisdictions.

A Change In Accounting Is Not Automatically A Change In Economic Substance

Changes in accounting rules, in themselves, should not lead to changes in issuer credit ratings (ICRs), since such changes do not denote an altered economic situation; they only affect the way the situation is reported. That said, where the application of IFRS 9 reveals additional fragilities that we had not previously identified, such as material weaknesses in provisioning policies or a substantial portion of higher-risk (but not impaired) assets, we would consider the impact on the rating.

As we explained earlier, higher loan loss provisions reduce our measure of capital, total adjusted capital (TAC), the numerator in our risk-adjusted capital (RAC) ratio, thereby reducing the RAC ratio. The projected RAC ratio is a key element of our capital and earnings assessment--one of the four bank-specific rating factors in our bank criteria--and therefore a lower projected ratio could lead to a lower score in this assessment. But that is not a mechanistic or automatic outcome. Rather, it depends on a number of factors, including whether we expect the ratio to cross the thresholds set out in our criteria. For example, a projected RAC ratio in the range of 7% to 10% would ordinarily mean that we consider the capital and earnings assessment to be neutral to the ICR (assuming the starting point of the rating--the anchor SACP--is at least 'bbb-'). In a scenario where the application of higher credit loss provisions from IFRS 9 means that a bank's RAC ratio falls below 7%, we would consider the extent to which that fall is likely to persist over time.

While a lower capital and earnings assessment would imply some pressure on the rating, it is possible that this could be offset by assessments in the other rating factors. In particular, we derive our view of a bank's relative capital strength and asset quality from our combined assessment of its capital and earnings and its risk position. While the capital and earnings assessment measures a bank's ability to absorb expected and unexpected losses, our risk position assessment considers a broader array of related factors, such as asset quality, underwriting standards, and provisioning relative to peers. The combined impact of these assessments can be positive, neutral, or negative to the ICR.

Here's An Example Of The Interplay Between Our Capital And Earnings And Risk Position Assessments

In the context of IFRS 9, the interplay between our capital and earnings and risk position assessments is best illustrated with a hypothetical example. Bank A is a European retail bank with a projected RAC ratio of 7.1%, and our current assessment of its capital and earnings is adequate, meaning it is neutral. However we assess Bank A's provisioning policy as more aggressive than its peers, and we reflect that in our moderate risk position assessment, meaning that it is credit-negative. Taken together, the combined assessment of capital and earnings and risk position has a one-notch negative impact on the ICR. On the application of IFRS 9, provisions increase significantly such that:

- The projected RAC ratio falls below 7% and we expect that to remain the case; and
- We no longer regard its provisioning policy as out of line with its peers.

In that scenario, all else being equal, Bank A's capital and earnings assessment would worsen (to moderate from adequate) but its risk position would improve (to adequate from moderate). The combined assessment of capital and earnings and risk positon remains negative to the ICR, by one notch. The ratings components that make up the ICR have changed, but the ICR itself has not changed.

Over Time, Banks May Modify Their Lending Appetites

In the longer term, the application of IFRS 9 may cause banks to change their strategies. For example, they could shift toward shorter-duration loan products from longer-term loan products, to achieve a more favorable accounting outcome. Similarly, we could see a move toward higher pricing on certain loan products (such as corporate loans or mortgages) to compensate for the higher loan provisions that they would attract even if they were not impaired. This could have a widespread market impact if peers sought to make similar adjustments, creating a shift in the supply of credit to the market, the pricing of that credit, and so the related risk-reward profile in some segments of lending.

We could consider such a change in our assessment of a bank's business position. At the extreme, it could even affect our view of a system's industry dynamics, as captured in our banking industry country risk assessment (BICRA) analysis.

The Basel Committee Is Likely To Visit This Topic

Although many banks are likely to see a fairly significant uptick in provisions on their accounting balance sheets due to IFRS 9, the impact on CET1 regulatory capital ratios will likely be limited. The Basel Committee has issued amendments to Basel III capital rules that allow for the impact of IFRS 9 to transition into regulatory capital over a period of three to five years, with full disclosure required of the fully loaded impact on capital over that period.

Where banks do not take up the transitional relief set out by the Basel Committee (or are not permitted to under their jurisdictional regulatory requirements), the current CET1 deduction of the excess of regulatory expected losses over accounting provisions will absorb some of the increase in accounting (IFRS 9) provisions before affecting CET1, for banks using internal ratings-based approaches in their regulatory capital calculations.

In the meantime, the Basel Committee will undoubtedly seek to revise its capital rules to address the move to expected credit loss models in accounting, not least because credit loss provisioning is a fundamental element of banking soundness. We doubt that banking regulators on the Basel Committee will want accounting rules alone to be the exclusive determinant in this important area. The fact that IFRS and U.S. GAAP have adopted different approaches to credit loss provisioning provides a further impetus to formulate capital rules that, at the very least, maintain the current level of consistency and comparability in expected loss calculations for regulatory capital ratios.

We See New Complexities Leading To Market Confusion

A move to IFRS 9's more forward-looking provisioning model will inevitably require a greater level of judgment by bank management teams about future outcomes. In turn, that may bring a greater level of divergence in approaches to provisioning, adding a further layer of complexity to peer analysis.

In particular, judgments about when a loan moves from stage 1 (which requires a 12-month expected loss provision) to stage 2 (which requires a lifetime expected loss provision) are dependent on managements' assessments of whether there has been a significant increase in credit risk (SICR) of the loan since origination. While the IFRS 9 rules set out some indicators for management to consider SICR, there are no hard-and-fast quantitative metrics mandated in the standard. We believe this will lead to inconsistent application of the requirements in practice. Specifically, banks may differ in their interpretation of what constitutes SICR, and local regulators and enforcers of IFRS in each jurisdiction may set out their own interpretations for their banks to follow. These factors could undermine the usefulness of the information because it would undermine analysts' ability to fully understand the basis of the credit losses and compare across peer companies. That is why clear disclosures about the basis of the judgments made by management in assessing and measuring expected credit losses will be important to help unpick the complexities that the new rules bring.

In addition, the lack of convergence between U.S. GAAP and IFRS means impairment analysis will be based on two markedly different accounting approaches, creating unnecessary reporting and market confusion and undermining peer analysis. Credit loss allowances and key metrics that are not directly comparable create significant disadvantages for investors. In the absence of greater similarity and consistency between IFRS 9 and the forthcoming U.S. GAAP rules, we believe investors would be best served if banks using IFRS disclose their estimated lifetime credit losses--even though IFRS 9 does not specifically require this.

Pro-Cyclicality: The Known Unknown

The timing of IFRS 9 implementation is—more by chance than by design--broadly fortuitous, given that the restructuring of balance sheets and rebuilding of capital that took place in the aftermath of the financial crisis is largely complete for many of the most affected banking systems around the world. Moreover, credit losses are relatively low across many of these banking systems. As such, banks are better positioned to absorb the hit from an increase in provisions, and that increase is lower than it would have been in the earlier years after the financial crisis.

As and when economic cycles turn downward, the potential procyclical effects of IFRS 9 will become clearer. These arise primarily from IFRS 9's requirement to move from a 12-month expected credit loss (ECL) for performing loans to a lifetime ECL when loans are assessed to have experienced a significant increase in credit risk. Some market participants refer to this as a cliff-edge effect. The effect could be amplified for banks operating in a single market, as a major macroeconomic change in that market, such as a large increase in unemployment, could mean that a large proportion of the loan book migrates to lifetime ECLs at the same time.

That said, IFRS 9 is not being applied in a vacuum. The impact of management strategies or regulatory actions could take the edge off the cliff. For example, management may choose to maintain capital buffers at higher levels during good times. They may move to reduce cyclicality in their lending portfolios over time. Regulatory requirements for countercyclical capital buffers, which are designed to be drawn upon in downturns, may also help to offset potential procyclicality.

In our view, if IFRS 9 is applied as intended, the risks of procyclicality may not be as significant as some market participants fear. Timelier, more transparent recognition of credit losses should be positive for bank investors, reducing concerns about "hidden" capital adequacy issues.

IFRS 9 In A Nutshell

IFRS 9 is the new financial reporting standard for financial instruments. Specifically, it sets out the requirements for the classification and measurement of financial instruments, the impairment of financial assets, and hedge accounting (see figure 2). IFRS 9 was developed as a response to criticism that the previous standard (IAS 39) led to the delayed recognition of credit losses by banks.

Figure 2

Key Components Of IFRS 9

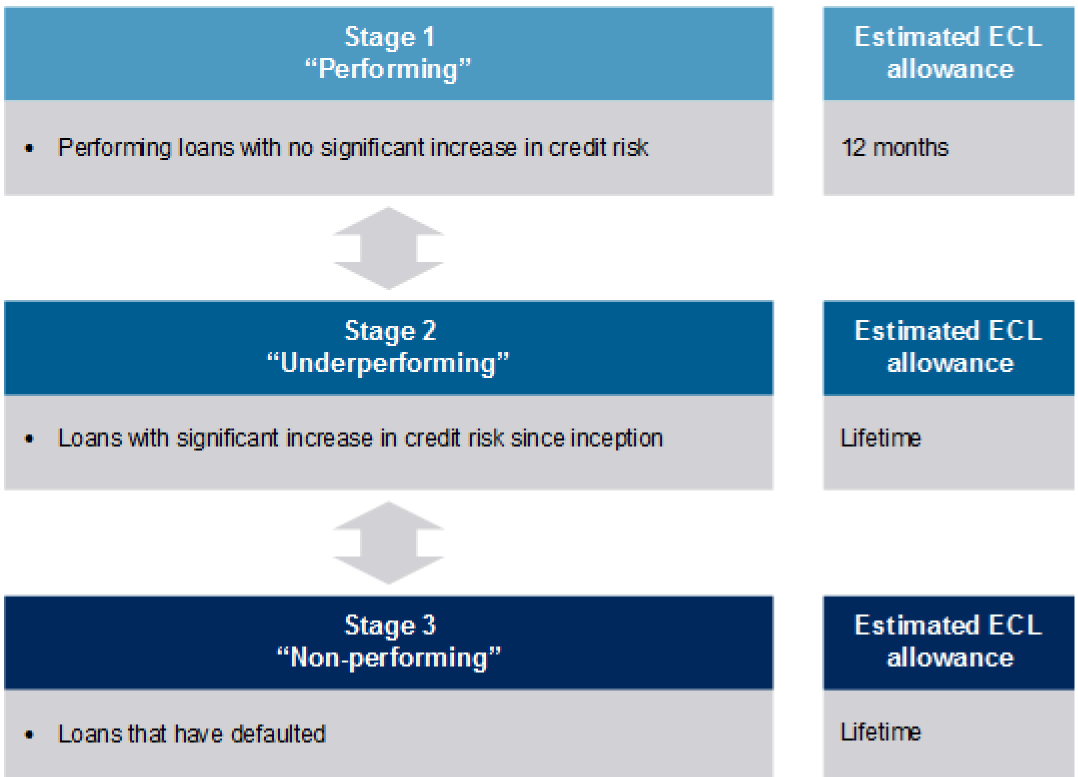
Classification and measurement	Impairment	Hedge accounting
Financial assets Three categories of financial asset, based on the business model for managing the asset (assessed at portfolio/business level) and the asset's contractual cash flow characteristics (assessed at instrument level). **Financial liabilities** No change from IAS 39 except that own-credit gains and losses are recognised in equity, not P&L.	• From an IAS 39 incurred loss model to an IFRS 9 expected loss model • 12 month expected loss provision for performing book, lifetime loss for underperforming and nonperforming book • Includes off balance sheet exposures • Macroeconomic considerations must be incorporated	• Aligns hedge accounting more closely with risk management • But... no change to macro hedging so no major change for banks

Source: S&P Global Ratings.

The key change--and the focus of this article--is the move from IAS 39's "incurred loss" model for credit provisioning to IFRS 9's expected loss model. In broad terms, IFRS 9 will require banks to recognize a credit loss allowance that represents 12 months of ECL for all performing loans, updated at each reporting period; and for significantly underperforming and nonperforming loans, an allowance based on an estimate of lifetime ECL (see figure 3).

Figure 3

IFRS 9: More Forward-Looking Provisioning



As indicated by the arrows, the staging of assets can move in both directions. For example, an underperforming loan (stage 2) can move back to performing (stage 1) if it is no longer considered to be subject to a significant increase in credit risk. Source: S&P Global Ratings.

In our view, the requirement for a 12-month expected loss provision on all performing loans and a lifetime expected loss provision on underperforming loans will cause loss provisions to increase when banks initially apply IFRS 9. Thereafter, the volatility of the provision is also likely to be greater, as banks review and update their expectations about future conditions at each reporting period.

Related Criteria And Research

Related criteria

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011

Related research

- How IFRS 9's Expected Credit Loss Framework Will Affect Canadian Banks' Loss Provisioning In 2018 And Beyond, Dec. 18, 2017

- The Overall Effect Of IFRS 9 On Rated Gulf Cooperation Council Banks' Financial Profiles Will Be Manageable, May 29, 2017
- Could Ballooning Loss Reserves From New Accounting Rules Deflate Bank Capital Ratios? Sept. 9, 2014

Only a rating committee may determine a rating action and this report does not constitute a rating action.